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Investment of Public Pension Funds

Assembly Committee on Public Employees and Retirement

Senate Committee on Public Employees and Retirement

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JOINT INTERIM HEARING

ASSEMBLY COMMITTEE ON

PUBLIC EMPLOYEES AND RETIREMENT

AND

SENATE COMMITTEE ON PUBLIC EMPLOYMENT AND RETIREMENT

In the Matter of:

INVESTMENT OF PUBLIC PENSION FUNDS

COUNTY ADMINISTRATION BUILDING
1600 Pacific Highway
San Diego, California

Tuesday, November 17, 1981

9:30 a.m.

Cathleen Slocum
C.S.R. No. 2822

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JOINT INTERIM HEARING

SENATE COMMITTEE ON PUBLIC

EMPLOYMENT AND RETIREMENT

AND

ASSEMBLY COMMITTEE ON

PUBLIC EMPLOYEES AND RETIREMENT

In the Matter of:)
)
INVESTMENT OF PUBLIC)
PENSION FUNDS)
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COPY

COUNTY ADMINISTRATION BUILDING

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SAN DIEGO, CALIFORNIA

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TUESDAY, NOVEMBER 17, 1981

9:30 A.M.

Cathleen Slocum
C.S.R. No. 2822

SENATE COMMITTEE MEMBERS PRESENT

Senator Newton R. Russell, Chairman

Senator James R. Mills

SENATE COMMITTEE MEMBERS ABSENT

Senator Paul Carpenter

Senator John Francis Foran

Senator Ollie Speraw

SENATE COMMITTEE STAFF PRESENT

Sidney T. Kaufmann, Senate Actuary

Mary Train, Committee Secretary

ASSEMBLY COMMITTEE MEMBERS PRESENT

Assemblyman Curtis R. Tucker, Chairman

Assemblyman Larry Stirling

Assemblyman Dave Elder

Assemblywoman Gwen Moore

ASSEMBLY COMMITTEE MEMBERS ABSENT

Assemblywoman Marian Bergeson

Assemblyman Peter Chacon

Assemblyman John Lewis

Assemblyman Bill Lockyer

ASSEMBLY COMMITTEE STAFF PRESENT

Dave Cox, Senior Consultant

Jim Bald, Minority Consultant

Robbin Lewis-Coaxum, Associate Consultant

Deborah Reed, Committee Secretary

I N D E X

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P R O C E E D I N G S

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CHAIRMAN TUCKER: Good morning, ladies and gentlemen.

This is a Joint Committee Hearing of the Assembly Public Employees and Retirement Committee and the Senate Public Employment and Retirement Committee. Senator Newton Russell is going to Chair the Committee this morning. However, his plane will get in at 9:15 and he might be just a few seconds late, at which time I will turn the gavel over to him.

In the meantime, I'd like to make a statement. As Chairman of the Public Employees and Retirement Committee I would like to make my position very clear. I agree with the importance of securing the highest rate of return on public pension fund investments. However, in my mind, of equal importance is to insure the integrity of public pension investment funds. So we must never lose sight of the prime purpose of these retirement funds; that is, to help fund the pension costs of public employees. Therefore, I would appreciate each witness who proposes some sort of liberalization of the laws governing investment of public investment funds, to also address the following questions: what safeguards should be placed in the law that would assure the numbers of California's various public retirement systems that their funds are being safely invested and that upon retirement their benefits will be paid?

Those persons who have a lengthy written testimony like 10 or 15 pages, I would appreciate it very much if you do not read it. Summarize it and if you have any copies, give it to the Sergeant-at-Arms. They will give it to the members of the Committee.

I would like to call Dr. Brian Neuberger.

If you feel that you must read your testimony, then go right ahead. That is a little deviation from our past policy. I generally don't allow that, but we are going to do it this morning because I'm not chairing the Committee.

Dr. Brian Neuberger of the Department of Finance, San Diego State University; are you here?

Well, I guess we'll wait until -- it's almost 9:30 now.

Okay. Dr. David Shulman, Business Forecasting Project, University of California, Los Angeles. Dr. Shulman.

I'd like very much for the record that everybody who comes and testifies, even though we will call your name from here, please state your name and who you represent. The proceeding I think is being transcribed, and speak slowly so that the young lady can hear what you say.

You may proceed, sir.

DR. SHULMAN: Mr. Chairman, Committee members, my name is David Shulman. I'm with the UCLA Business Forecasting Project. I'm also an assistant professor at UC Riverside.

CHAIRMAN TUCKER: May I interrupt you? I saw San Diego last night and I didn't finish seeing it until the wee small hours of the morning. I'd like to introduce my colleague, Assemblyman Larry Stirling, who represents this area and who is also Vice-Chairman of the Public Employees and Retirement Committee of the Assembly.

Please proceed, sir. I'm sorry. And Senator Jim Mills is coming in. He's on the Senate P and R Committee.

DR. SHULMAN: I also am a part-time consultant to the Governor's Office on this issue, but I am not in any way, shape or form representing the Governor's Office this morning.

CHAIRMAN TUCKER: Can you pull the mike closer to you and speak right into it?

DR. SHULMAN: I am also a part-time consultant to the Governor's Office. On this question, the testimony I'm going to give today in no way should be construed to represent the position of the Governor's Office. That's only incidental to my being here today. I want that in the record.

I was told to discuss the UCLA forecast outlook for the US economy to sort of set up some kind of framework for the Committee as to where the economy is and where we see interest rates. Basically this is our tentative view, and we will have final views that will be available to the public on December 10th, 1981. These views are tentative and subject to change over the next couple of weeks, but the basic outlines of the way we look at the economy between now and 1984 are reasonably clear. When we say "our view," it means our view, not necessarily the way the economy is going to go.

One, we're obviously in a major recession in the economy, and the recession and the credit status of the industry of autos and housing will worsen and it will spread to other sectors of the economy in that broad based traditional recession. California will not be immune to this recession, and we are going to suffer roughly in line with the national economy. We are not going to be an exception this time. In 1980 we were an exception, in 1974, '75 we were an exception to really what was going on in the national economy. We were doing a lot better. This time we will not be an exception. We are going to suffer with the rest of the economy.

We are in the process of a transition from, hopefully, from a high inflation economy to what is, hopefully, will be a lower inflation economy. That's the transition we're going through right now. This transition is going to be painful, very painful indeed and it will be accompanied by high rate, high real rates of interest which in a sense is good for the pension funds in the sense that they can earn a higher rate of return than otherwise would be earning in a normal interest rate environment. I will get back to that in a little bit.

The real gross national product which was down modestly in the second and third quarters of this year is now coming down very hard, and this quarter is going to be down quite substantially and we'll probably see continued decline through the first quarter of next year and possibly the second quarter of next year.

In terms of unemployment, we will probably get up to the 9 percent area. This will also be for the state of California as well as nationally, and probably be in the high 8 percent, possibly 9 percent by the first quarter of this year.

For those of you who worry about the federal deficit, we will be at $70 to $80 billion area fiscal '82 and there's no chance of the balanced budget by 1984. Probably later as well, '85 also.

We look at a recovery to begin slowly and then pick up in the second half of phase two of the federal tax cut, the recently enacted federal tax cut to begin to take effect.

Inflation as measured by the Consumer Price Index is expected to be in the 8 percent range in 1982, slightly lower in '83 and '84. This is dug in back to the question of the lower rates of interest. With long-term bonds yielding approximately 14 percent right now, 15 percent, and 8 percent inflation rate would give a real return of 7 percent. This is unprecedented in the post-war experience with a real rate of at most of 2 and 3 percent and we now see 7 or 8 percent real rates of return on long-term buying. That is unprecedented.

Short-term interest rates will probably drop into the single digit rate as far as treasury bills go. They're now at nine and three-quarters percent, and it's very possible to see 8 or 9 percent treasury bills very, very soon. The prime rate in terms of prime rate which is about 16 percent today will probably be as low as 13 percent in the first quarter. This is due, this is primarily due to a drop in the demand for credit caused by the recession. That is what's bringing down interest rates as opposed to interest rates sort of following inflation rates down painlessly.

Long-term interest rates which is what pension funds primarily long-term bonds which the pension funds primarily invest in at long-term rates are probably going to stay stubbornly high, 13, 14 percent kind of range, but the direction to us seems to be decisively down. This means that long-term bonds bought today will be bargains because the rates that we're going to see today will look very, very high five years from now just as the rates of a few years ago seem very, very low. It's interesting to note that 1946 American Telephone sold bonds to yield two and five-eighths percent. Those bonds are still outstanding in the year 1986, 40 year bonds. Those investments were disastrous. I think it's important to realize that you should not extrapolate the experience of the bond market from 1946 to 1981 -- that's basically a 35 year experience -- and extrapolate that experience from 1981 to the year 2020 and say that interest rates went up by a factor of 6 or 5. In the post-war period we'll go up by another factor of 5 or we'll have a 10 basic point increase in the loan rate of, say, 24, 25 percent. The reason why bonds have been a terrible investment in the post-war era is that interest rates have been increasing continuously from basically 1951, '52 on to the present day with the exception, I guess, of the last three weeks. Three or four weeks ago there probably was a single bond rate somebody had profited unless they were on the short side of the bond market. So I think it's important to realize when looking at historical experience, if you have a belief that the long-term inflation rate is going to be coming down gradually and we're out of double digit inflation for awhile, the performance of bonds is going to be a lot better in the 1980's than they have been in the 1970's. When the 1970's was started we had inflation that was started in a modest level, 4 or 5 percent and doubled to around 10 or 11 percent. If we don't in 1980 and we reverse that, if you go into the '80's with 10, 11 percent inflation and we come out of the '80's with 5 or 6 percent inflation, long-term bonds are going to be very, very attractive investments for pension funds, individuals and what have you because they will increase in price. So I think that is an important thing to look at.

The most critical question I think facing the economy right now is whether or not the slow money growth policy of the Federal Reserve will choke off recovery late next year before it really gets going. That's the really critical question, whether or not interest rates will run back up in terms of the prime rate back up to 20 percent late next year or early in 1983. Will be going down now. The question is do they come right back up or do they stay down or if they go up do they just go up a little bit. That is going to be really the critical question. The history of the last three years has been whenever interest rates dropped, they went right back up again and bumped up against sealed economy, so they bumped up against the money ceiling and then the economy declined. For example, 1979 you got a major decline in the economy in the second quarter as a result of the energy shock associated with the revolution in Iran. The second quarter of 1980 we had a major decline in the economy as a result of the incidents of credit control and the high interest rates that took place in the first quarter of 1980.

1981 we're having a traditional recession. Essentially there's been no growth in the economy for three years right now and the question becomes is whether or not the tight money policy in the Federal Reserve that has followed since the end of 1979 is going to say one more time it's not going to let the economy advance. Interest rates will shoot up until the inflation is really wrung out of the economy. Wringing inflation out of the economy is a very painful process. We were led to believe early on in the year by the Administration -- and by the way, I support most of the programs by the Administration in Washington -- that this process was going to be easy and the process was going to be painless. The fact is to break this inflation there's going to be a lot of pain in the economy. There will be a lot of corporate bankruptcies and there will be high unemployment and there will be, indeed, recession. I think that's just the reality of doing that. I hope that the suffering that this causes will sort of come out on the other end as an upside in the sense that we do have a lower inflation economy in '82, '83 and that the pain that we're going through now is sort of worth it.

Briefly, to comment on the bills before you, generally as an economist, the more investment opportunities one has, the better off one is. I mean, the general question is if you open the area to invest, the better off someone is. A pension fund does not have to exercise all the opportunities that are given to it. I think that is a question that the investment managers have to decide. But you have the opportunity is something that's an advantage to a pension fund. Whether they use it or not isn't the question. It's to have the opportunity is an advantage. Now, if you believe that pension managers somehow will run wild with having extra opportunity in investing things that the Legislature would not want them to invest in or beneficiaries would not want them to invest in, that becomes another question. But if they stick to the fudiciary rules that are in the private sector, it gives some extra opportunity and probably makes sense.

The statement I would like to point out to the Committee that the traditional bond investments of pension funds looks like a wise course for the environment we have right now. If, in fact, you are disinflating the economy and if, in fact, we are going to have lower inflation by the end of the '80's than we have now by a significant amount, say, 5 or 6 percent inflation -- I think it's really possible to have it down that low -- then a bond investment strategy makes a lot of sense for pension funds and you're really not going to be giving them that much. Just the fact you go back into a higher inflation economy, then an equity strategy would make sense to give the pension fund an opportunity. Given the volatility of the economy you have more equity probably would make sense to speak to in general without getting into the specifics of the legislation you have before you.

With that I'll be open to questions.

CHAIRMAN RUSSELL: Are there any questions from the Committee? Mr. Stirling.

ASSEMBLYMAN STIRLING: Doctor, you indicated that bonds might be a good investment. How would they in your scenario compare with equities over the same scenario of the economy?

DR. SHULMAN: In the early phases bonds will do a lot better than equity as they have in the past. Say, since May, to give an example, there's been a lot of volatility in both the bond market and stock market. Since May the stock market is down around 10, 50 percent and dividend yields annual rate is about 5 or 6 percent. Bond market is up 6 percent, let's say, and people in the bond market were holding at 14 or 15 percent interest eight months away. There has been a lot of volatility in both markets. So let's just say in the past six months. The returns from bonds, say, projecting down two or three years could be higher than from the equities for the next two or three years. The next ten years is unlikely, but the next two or three years returns from bonds in our scenario could be quite significant. Much better than equities, especially when this disinflation period profits are going to be weak. The stock market responds more to the decline of corporate profit than it does to low interest rates as it seems to be doing right now. Then the stock market is going to be a weak area to invest while the bond market, high quality bonds will do very well. That's been the case for the past month anyway.

CHAIRMAN TUCKER: Dr. Shulman, are there any changes in the state or federal laws that you would like to see occur that would enhance the earning capabilities of the retirement portfolio?

DR. SHULMAN: I would think as a reasonable hedge. I think, given the uncertainty of inflation, given the uncertainty of the world we live in right now, if this inflation scenario is not correct I think it makes sense to have some portion of their portfolio in equities because they need something that's going to rise with inflation. I think that is absolutely essential.

The other thing is that as the volatility of the economy increases, bonds have interest as volative as stock. So from a volatility standpoint, the risk to the bonds and the risk to the stocks -- measured the way an economist would measure it, not measured the way somebody off the street would measure it -- have been practically the same in that bonds will move up and down much more compared to, say, the early '60's or the early '70's the bonds hardly moved. We had a movement in the bond market in the past six months that used to take ten years in the bond market took place in the last six months. So in that sense the safety in bonds in that sense might be looser too, if we do go off into runaway inflation in the economy, the pension funds sitting there holding bonds would be as safe as the pension funds were that bought bonds back in 1946 at two and five-eighths percent and that pension fund basically would face serious difficulty today. So to have some equity position and have something that will move by an increase in value with inflationary economy would make sense to have that option, yes.

Now, what percentage will that -- that's another question.

CHAIRMAN RUSSELL: This may be a little bit out of your purview, but would you care to comment on the constitutional amendment that would provide a certain small percentage for what they call venture capital as investment opportunity for pension funds? It may not be in your expertise. Do you have any comments on that?

DR. SHULMAN: In a large portfolio -- this was one of the concerns that Senator Benson had around ERISA, the federal statue for the private plans. In a large portfolio,

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given the diversification and given the liquidity requirements of the fund, it might make sense to set aside a very small portion of the fund for venture capital investments. Now, the problem with venture capital investment as an economy of scale if it takes a lot of time and effort and it's costly to do that. In a sense it makes sense, but you have to analyze how much it's going to cost basically to develop the expertise to do venture capital if that can be done at reasonable cost to the fund administratively.

CHAIRMAN RUSSELL: Would you explain what you mean by cost of monitoring and administering venture capital?

DR. SHULMAN: Much harder to invest in small companies than to invest in, say, IBM or American Telephone because they have to be watched closely and they're much more volatile and especially if they're not publicly traded securities. So there is that kind of a probable return, Potential returns could be very, very high and the risk is very, very high as well. The question becomes an economy-wide question, is most of the new inventions and most of the jobs get created by small companies and the major pool of capital the large pension funds. So if small companies can't avail themselves of tiny portions of that capital, we may have less smaller companies and as a result less innovation and less jobs created. That is a major tradeoff that has to be looked consistent with the fudiciary responsibility of the fund. It makes no sense for us to have entire portfolios in venture capital. That would make no sense at all. Now, if 1 or 2 percent of the portfolio in some kind of a venture capital situation where the administrative costs of running that money would be low might make sense.

CHAIRMAN RUSSELL: That would mean we'd have maybe half billion to a billion dollars available from the two major systems for venture capital if the bill was to go through. Do you think that amount of money available, which wouldn't necessarily have to be used, is an excessive amount even though the systems are $700 billion or more in assets?

DR. SHULMAN: Well, I don't want to comment on what's excessive or what isn't. If you said 25 percent I would probably say that was excessive. But I don't want to go 2 percent or 3 percent numbers and 5 percent, I don't want to really comment on that because both funds have substantial unfunded liabilities, both funds have to look at that within an array of assets available in the market. In today's environment I would probably be reluctant to have that much committed in that area. In a different environment you might want to go up to some maximum amount of numbers. I would be reluctant to put down on a number some modest amount if, in fact, it could be done on a low cost basis. If you have to hire a lot of staff to run, this is the most expensive money to run.

CHAIRMAN RUSSELL: Is it need -- first of all, I guess what you're saying, it needs an array of experts who would go in and examine the various opportunities that would be offered, choose a few and continually monitor them?

DR. SHULMAN: Yes. Those deals are very difficult to do. When they offer higher return and higher risk. They're difficult to do. If your fund manager used to buying IBM or used to buying bonds, it's going to be in a different environment in the venture capital market. A much different environment that will require gearing up in order to invest successfully in that area.

CHAIRMAN RUSSELL: Senator Mills has a question.

SENATOR MILLS: We have a number of changes in the requirements suggested by this constitutional amendment. But I think personally the probably reason to put to you and to some other witnesses, what should the restraints be that the state imposes, ideally, what limitations should be placed upon pension funds? Obviously there are a lot of different categories of funds that allow different categories of investment funds represented by their management. How far should the state step into this?

DR. SHULMAN: If you take a look, the private standard is ERISA. I would think that the ERISA standards which allow a lot more equity than the state standards would make sense. ERISA was not imposed on state and local government for a whole bunch of reasons, and those state standards are far stricter than the ERISA standards. The ERISA standard is stricter on the unfunded liabilities. The funded liabilities is a very, very strict standards which state and local governments were not put under, but for the political reasons there were substantial tax increases to fund those liabilities. But the ERISA standard to me is a reasonable standard which is a very, very mild standard compared to the existing standard. So that would be a reasonable standard.

SENATOR MILLS: You're not saying that the ERISA standard should be applied always. That is to say, were you suggesting that we should leave standing the exemption for unfunded liabilities for governmental plans or that governmental plans should be required to conform to ERISA in all respects?

DR. SHULMAN: I feel we face a very serious problem with the unfunded liability of the plans, and that's a burden on all the taxpayers of the state and the future taxpayers of the state that will have to be met. We can either fund the plan now or fund the plans later. We're going to have to pay higher taxes to do that.

SENATOR MILLS: We don't have to fund them any time. We just have to cover the costs from year to year.

DR. SHULMAN: But basically when those costs come due, it means a higher tax burden ten years from now than there is today. That's effectively waiting until it comes due. It means that there's a higher tax burden in the future.

SENATOR MILLS: I agree with that, but the question is what do you mean by funding? We have talked about funding these plans and, as you know, it just has been a terrifying thing to consider actually funding. From time to time we thought about going part way or eating our way slowly into funding or at least not allowing the unfunded liability to increase, that kind of thing.

DR. SHULMAN: Well, the ERISA standard give a plan

40 years, gave a plan 40 years to be fully funded. This is a fundamental burdon on the people.

SENATOR MILLS: I once carried a bill that applied such standards for transit operations and got into a lot of trouble for doing it. It passed, but there may have been one or two people on this side of this desk, one person on this side of the desk that wasn't happy about that.

CHAIRMAN RUSSELL: All right. Thank you very much.

DR. SHULMAN: Thank you, Mr. Chairman.

CHAIRMAN RUSSELL: We're going to deviate from our agenda to accommodate Mr. James Blanchard who has to leave at 10:30. Is Mr. Blanchard here?

MR. BLANCHARD: Yes, I am.

CHAIRMAN RUSSELL: Would you please come forward and then we'll go back to the regular agenda. Dr. Neuberger will be after Mr. Blanchard.

State your name for the record, please.

MR. BLANCHARD: My name is Jim Blanchard. I'm Vice President of A. G. Becker, Inc.

CHAIRMAN RUSSELL: Which is?

MR. BLANCHARD: An investment banking house. The portion I work for measures the performance of pension and profitsharing plans, how well they do, how well their management does.

CHAIRMAN RUSSELL: You have to use the microphone like that. Otherwise no one will hear you.

MR. BLANCHARD: Should we start over again?

CHAIRMAN RUSSELL: No.

MR. BLANCHARD: We measured performance of pension funds. We measured performance of several public funds in the state of California, eleven 37 Act counties, PERS, several of the cities and smaller municipalities. The information that I wanted to share basically has to do in some degree with what Dr. Shulman was just talking about, the volatility, the benefits of flexibility and what that's meant with regard to performance, just historic information. Dr. Shulman indicated the past history is not going to be a good indication of what's going to go on in the future. About all I can share with you is history.

We have a lot of information which I believe I shared with your Committee, Senator Russell, eight months ago which would indicate that historically public funds have held substantially fewer dollars in equities as a percentage of the overall dollars than the general population of pension profitsharing plans. Currently public funds are median. The median public fund in our universe is about 250 to 300 funds, hold about 32 percent in stocks, about 50 percent in bonds which your limitation of 25 percent that puts you under the median and over the last ten year period of time the performance of all of the public funds that we measure here in the state of California is below the median of the public funds that are measured all over the United States primarily because of the fact that the equity performance, whether it's good or bad, there hasn't been enough of it to influence performance. The changing of the law which Mr. Tucker referred to a little earlier, he suggested we should talk about the risk as well as the potential reward. I think the key point I hear when I talk to the various boards around the state and also that we have an opinion on is that flexibility appears to lend more opportunity for performance. There's two things that basically you need to get good performance, and one is good selection and the other is good timing. You basically eliminated to a great degree the ability for timing to do a lot for you. We have had lousy bond markets, as you're very well aware, since '77 and actually earlier than that and excellent stock markets have stopped at the beginning of '81. The ability to go into stocks then and perhaps move out subsequently would have had a substantial performance. The majority of the funds I see here in the state, even if they're limited to 25 percent could not participate in that particular opportunity to move in around the marketplace.

Dr. Shulman mentioned that historic returns for stocks are substantially above inflation over any period of time over ten years. I have some information that was cited by Ibbotsen & Sinquefield which over 56 years proves that stocks have historically returned six and a half percent above the level of inflation and bonds have returned historically about a tenth of one percent over inflation for that same period of time. So if you look at history as a guide, you would expect that stocks over a long period of time have some advantage that weigh overinflation.

CHAIRMAN RUSSELL: Is it not true that as you look at all these factors you can take certain periods of time, one year, four years, eight years, fifteen, twenty years and the different mix will come up with a different result? A short-term may look like a loss, but in the long-term it's a better deal.

In your business relationships, do you find that those who are not dealing with this issue as you are and fund managers are tend to view incorrectly the pension investment funds from the normal lay person's short-term perspective and judge pension funds and results on that basis rather than a long-term and, if they do that, in your opinion is that correct or incorrect?

MR. BLANCHARD: If I understand the question --

CHAIRMAN RUSSELL: It was rather long and involved.

MR. BLANCHARD: What you were asking is does it generally appear that the people who are not professionals in this area will view the results of pension funds and the manner in which they're managed from an incorrect point of view.

CHAIRMAN RUSSELL: Short-term.

MR. BLANCHARD: Short-term. Most people who sit on boards, even corporate plans and county plans, state plans, look at the quarterly and six-month results as an indicator of what's going on. When I'm doing a report for any of our clients, I emphasize two to three years. If I'm asked what period of time a policy should be measured over I talk about a market cycle four or five years, whichever is shorter. You cannot assess the effect of either selection or market timing in a shorter period of time. You can look at trends, but that's about all.

CHAIRMAN RUSSELL: I know that the Legislature is oftentimes critical of the performance of our two major systems saying it should be this or should be that. As you look at a system, it depends really how old the bond portfolio is when they started buying it as an old system would produce a result that's quite markedly different, even with excellent management, than a new system; would it not?

MR. BLANCHARD: In the recent bond market that's true because of the rather unprecedented rate in the bond market currently and the restrictions that your particular systems have on being able to invest in other than bonds. What we would recommend, and what we always suggest that someone look at, is performance, A, relative to other people with the same kind of restrictions which is really hard to do and, secondly, performance in relationship to either the benefits or the actuarial requirements of the plan or inflation. We prefer inflation, but sometimes the plan is set up to handle just the actuarial realities which are generally much lower than inflation.

When I write a policy for a plan or help somebody do that, we always tie the performance to inflation, a real return over inflation over a market cycle period of time. Shorter than that just doesn't seem to make any sense.

CHAIRMAN RUSSELL: Thank you. Continue.

MR. BLANCHARD: The basic, I suppose, the basic point I would want to share is that because of the fact this is permissive as opposed to mandatory legislation that you're talking about that the additional flexibility in our view, based on the history that I can see, would allow the opportunity for timing which is not allowed now within the systems where you can move in or out of whichever asset would benefit the fund. It would be wonderful to move into equities in '75-'76. It would have been very nice to move out of them at the end of '80. It's a more difficult decision perhaps to make than which stocks to hold forever or which bonds to hold forever. But it appears, based on the best information we have over 18 years of doing this, that those managers who have more flexibility, who time the market or at least attempt to do that have had better results.

CHAIRMAN RUSSELL: Have you had a chance to look at the SCA 21?

MR. BLANCHARD: Yes, I have.

CHAIRMAN RUSSELL: Do you have any observations you'd care to make as to direction it's moving, whether you think its position should be different, some other mix or any comment at all that will be helpful to us?

MR. BLANCHARD: SCA 21 which would increase the opportunity for equity investments up to 50 percent seems to make some sense. The last time I testified before your Committee it went to 60 and came back down to 50 again. Fifty percent is the statute as it is now. Very few of the managers who manage the county funds that I deal with and the other public funds when asked a question have indicated that they wanted to go much beyond that at any particular time. I believe the 5 percent opportunity in what they call "prudent man" stocks, smaller stocks, will still be a limitation possibly more than should be held because, as an example, the last three years all of the action in the market, all of the good return in the market, the majority, if not all, the majority of the good return in the market came from smaller companies, a number of whom were excluded from consideration by your managers.

CHAIRMAN RUSSELL: Are you talking about the venture capital?

MR. BLANCHARD: No, sir. The 5 percent in what are called "prudent man" stocks. Stocks which would not meet the requirements of capitalization and dividend paying.

CHAIRMAN RUSSELL: Do you think that, looking at the long-term picture that that 5 percent should be increased? Today you might say one thing, but in the long-term should it be increased or is this a good limitation for safety's sake?

MR. BLANCHARD: I have a limitation in answering that question in that I feel primarily with very large funds who have at least one or two very knowledgeable people on their board or within their staff, I can see where in a case of maybe a small municipality that is covered by this, a money manager who wanted to really take some excessive risk in that area might abuse the privilege if it was much larger than that. However, it was a question at one time of whether under the old law constitution presently allows 10 percent "prudent man." It doesn't because of some legal adjustments with the constitution. But it appears to me that 10 percent would not be unreasonable and would in fact limit somebody in taking too excessive a risk. Again, my argument is for flexibility because I feel that that gives the opportunity for the best possible return. I do not, however, believe that an open-ended policy would make any sense.

CHAIRMAN RUSSELL: Do you think in the enabling legislation should SCA 21 pass, that we should incorporate some requirements on the smaller funds, whatever that is, "X" dollars must engage in certain kind of a counsel or something of that nature?

MR. BLANCHARD: Well, my company measures business, so I'm kind of prejudiced that they should all be measured. It does appear that there should be some consistent form of measurement comparing one to another that is relatively current, whether it's done inside or outside. As far as the kind of counsel, I believe the law requires they have to be registered and they should be. But to do beyond that would be very difficult.

CHAIRMAN RUSSELL: Okay. Any other questions from the Committee, staff?

All right. Thank you very much.

Now we'll go back to Dr. Neuberger, Department of Finance, San Diego State University.

Please let me remind you -- it's a little hard to remember -- this system is not the greatest here, with apologies to San Diego, but please talk very closely to the microphone because it's difficult for the people to hear.

DR. NEUBERGER: Mr. Chairman and members of the Committee, I consider it a privilege to appear before you today. For the record, my name is Dr. Brian Neuberger, and I am a Professor of Finance at San Diego State University.

The main purpose of the hearing, as I understand it from the the things I've been given by the staff, is to explore ways in which state, county and local governments can improve the performance return on public retirement system pension plans. As I mentioned, I had several questions proposed to me and I hope to summarize the statement which you've been given relative to that particular point. I hope that as a result of doing that I can stimulate some lively discussion from each of you on the Committee. I hope that I can make some positive, constructive comments as well as very provocative discussion relative to what pension plans have done, what should they be doing.

Relative to Dr. Shulman's comments, the question was asked what I thought about the overall economic environment. I think it's important to briefly state that before I talk about how I think pension funds, public pension funds ought to be administered and in certain sort of investments.

Just to make a brief observation about the California economic future, as Dr. Shulman pointed out, the overall United States economy we are in a period of recession which commenced I think the second quarter of 1981. My view is for all intents and purposes we have been in a recession as far as the U. S. economy since the beginning of 1979, what we might call stagflation. We had a period of basically no growth to speak of. Technically we had a recession last year and we're now in a recession at this point in time. We see evidence abounding relative to the effect of recession. Housing, of course, is severely depressed, the auto sector is really depressed. Those two sectors, directly and indirectly affect over one-half of gross national product. Oftentimes you hear people say, gee, the economy until recently wasn't doing that bad except the housing and the auto sectors. When you see the magnitude of that includes over half you can see what effect it has on the economy. The housing starts, for example, there are now somewhere around 300,000 unsold new houses and condominiums in the United States. There are over 5,000,000 existing homes for sale. That is a whole lot different than the 1973, 1975 recession. However, the rate of purchasing is a lot more than it was back in 1973 to '75 and the homes that are selling or at least have been purchased fall out about 50 percent of the time because the owner, that is, the prospective buyer cannot qualify for the loan. So the severity in residential real estate is a lot more severe in my view than it was back in the middle '70's.

CHAIRMAN TUCKER: Excuse me. You indicated that of all of those deals that they attempted to consumate, approximately 50 percent of them fell out because of the inability of the buyer to qualify.

DR. NEUBERGER: Yes.

CHAIRMAN TUCKER: Do you have any information on how many of those people that were successful in qualifying did in fact keep their investment safe by continuing to pay the premiums on it because that would be more important to me as far as the portfolio is concerned than how many fell out. We have no risk if they fell out.

DR. NEUBERGER: That's exactly true. In the state of California they estimate that up to eight or more percent of the houses that have been sold successfully in the last two or three years have been through concessionary financing or seller financing and a lot of those therefore were done through second, third, fourth trustees and a lot of those, of course, have terms of two, three, four years such as interest only, et cetera. So my view is we really haven't seen the total evidence of how severe that might be. Obviously you can make the payments on the assumption that interest rates are going to plummet, that your house is going to increase as it was in the early, middle '70's at two percent per month. But when that balloon payment comes due and it happens maybe you sold or transferred your interest, that's where the real waiting and the gnashing of teeth come in. I think we're going to see a lot of that now in the next two years. We have not yet seen the evidence of where the people can in the long term beat the payments.

CHAIRMAN TUCKER: And that is the risk of the retirement portfolio investing in real estate at this time.

DR. NEUBERGER: In residential real estate. Commercial real estate again is something else.

I mentioned state unemployment is now 8 percent and we're forecasting that it's going to be higher before we see the end of the recession. Industrial production, stock prices, of course, will move down. They're normally leading indicators of economic changes and they have forecast the recession we're now in. My view is that the recession will continue to accelerate probably through the first quarter of 1982 and then I would think that we will start to see a recovery, particularly the latter part of 1982.

As Dr. Shulman pointed out, we have now seen declines in short-term interest rates, gradual declines in long-term interest rates. Interest rates, therefore, declining in general. Inflation rates on an average are declining now to more of the single-digit variety from the double-digit variety. The prime interest rate has dropped from the all-time high in December, 1980 of twenty-one-and-a-half percent down to I think about sixteen-and-a-half percent today. No doubt about it I think the housing and the auto sectors would certainly recover significantly if we get long-term rates down much lower than they are right now. I think that's going to take quite some time before that occurs.

In addition, the Economic Recovery Act of 1981, signed by the President and will be in effect in 40 some odd days. One of the major incentives behind the tax cuts and also an attempt at reducing spending, is to get a long-term boost to capital spending in our economy. This is a very hot issue.

In the near term both stock and bond prices react very negatively to the Economic Recovery Act. I think, looking at my own personal experience, I have been very cynical in the last ten years particularly. I've been burned so long by investing in some fixed rate assets whose returns turned out to be less than inflation, that I referred to a guaranteed confiscation of my capital. This is one reason why we're not getting real rates of return much higher than inflation.

Investors have become very cynical, savers have become very cynical due to the adversity of the last ten years in financial assets as opposed to real assets such as real estate. I think we're going to see a reversal of that gradually. I think the key is that the Economic Recovery Act I think is a positive move in the right direction. We often forget that the tax cuts are only cuts in increases. The mathematics that sound like the second derivative. These cuts in the increases and the tax cuts that we're talking about are only effectively adjusting for the expected inflation in the next two-and-a-half years and it does nothing even with the bracket treatment that we've all experienced in the last couple of years where all of us have been making more and enjoying it less. So I think we need to go more in that direction. I think until the government becomes less of percent of gross national product we're still going to be experiencing strong underlying factors of inflation, but I think there's a positive move in the last few months. I think we're in a real watershed area, that is, what we do relative to the federal and state laws and regulations in the next three to four years to stimulate more incentives for the private sector will pretty well tell us what the year 2000 will bring. There were lots of legislation rules implemented in the 1960's which has brought us to the year 1981. Now, in addition, of course, we've had a lot of external shocks that may not have been forecasted such as oil pricing increases. I think in the end, and our whole concern here as employees and citizens of this great country, is that we want to maintain, if not increase, our real standard of living and that has been eroded in the last few years. My view in the end the only way we can do that is by working harder and/or smarter and doing it with better plant and equipment, that is, by enhanced productivity. I think the laws at the federal and state levels need to place more and more concern on stimulating incentives to save, to stimulate incentives to invest and do it with better plant and equipment. I think that we see the prospects of the remainder of the decade, I'm rather emulous. I think the last part of the 1980's that we will be in a better investment environment where savers are being rewarded adequately and investors are going to be rewarded adequately to borrow the money to enhance productivity. I forecasted in 1973 in a series of articles that appeared in the San Diego Union middle 1973 that we could expect inflation for the end of 1970's to range between 10 and 14 percent. This was looking at various economic variables over the 1960's period that would project what inflation will be. It turned out, of course, that forecast was basically correct. The result of that inflation had a tremendous effect on businessmen, investors, and government bureaucrats throughout that decade and that's of course what we're now experiencing. The likelihood that the 1980's financial assets for the short-term investments and equities will be superior in general to real assets such as real estate. A couple of reasons for that my view is from the standpoint of residential real estate is that the lender is no longer going to subsidize the borrower. So we pay for ourselves, the shared appreciation mortgages or SAMs and the adjustable rate mortgages or the ARMs. I think as a result of that we are going to see lower levels of inflation, particularly in real estate, than we saw in the decade of the 1970's.

CHAIRMAN RUSSELL: Well, at that point we are seeing a big push by various sectors of the economy to get pension funds to invest in real estate mortgages and all the new packages that relate to real estate. In your opinion do you think we should go slowly, should we blast into it or not engage in that at all?

DR. NEUBERGER: I think we should move into it, but move into it slowly. I mentioned specifically residential real estate is an area where I don't think we're going to have the speculative excess returns we had in the last decade. However, as far as the pension funds go, I think it gradually should be moving more aggressively into real estate equities relative to commercial types of property. But I mentioned being very, very cautious because, as we said before, we can all see the past is a good indicator of the future. We can always say in hindsight that if PERS or STRS or any other local fund had invested in real estate equities in the 1970's, their fund would have looked really super right now. I still would be encouraged to invest in real estate equities to at least a 10 percent level.

CHAIRMAN RUSSELL: Assemblyman Tucker.

CHAIRMAN TUCKER: You answered most of my questions. The pressure's on now that we should invest in single family dwellings and this is I guess why we're having all these meetings throughout the state because that is where the concern is and they indicate that there is a definite need for housing starts and you're telling us that there's a tremendous surplus of new houses on the market. I think we've been getting some wrong information. I mean, what is happening?

DR. NEUBERGER: There is a surplus of houses. It's just the fact that people can't afford to buy them. That's the real crux.

CHAIRMAN TUCKER: So there was no need for new housing starts now except to help the real estate industry, the construction industry because they're not moving those that they have on line now?

DR. NEUBERGER: That's correct. It's a question of social policy. Shall we continue to subsidize homeownership as we've done since World War II? Certainly more people own their homes and condominiums today than ever before due to policies which directed funds in that direction.

CHAIRMAN TUCKER: For a shorter term than any other time in the history of the nation because of the variable types of financing that we have. We have not really proven that it does anybody any good after living in a home for five years on a shared ownership basis to go home and tell their family we have to move. I don't know that -- well, I'm developing something in my mind that possibly isn't the intent of the hearing.

DR. NEUBERGER: Well, every generation since the turn of the century, every generation the kids have always started off better than the parents ended off, almost. I think we've hit a generation now where that is no longer automatic. In fact, it's a general standard of living. The current generation as the kids grow up may not end up as well off as their parents ended up. My view is we have a very high standard of living and we have a lot of great things to look for in our economy, but I'm not sure that the social policies should continue direct subsidation only to housing to the detriment of reindustrializing, increasing our productivity because in the end it's one thing to have a house and one thing to have a job to make money so they can qualify to have a house. So it goes together the increased productivity at the same time encouraging home ownership. I think you have to do both. You can't ignore one. We're seeing a shift in this policy I think at this point. Should they continue to subsidize housing and get people qualified to those 300,000 unsold homes and condominiums. That's the social question.

CHAIRMAN TUCKER: Is it wise to invest pension fund money into those endeavors?

DR. NEUBERGER: Depends on if you're talking about money for mortgages, money for investors as far as --

CHAIRMAN TUCKER: I'm talking about the portfolios for a retirement system.

DR. NEUBERGER: Investment mortgages?

CHAIRMAN TUCKER: Yes.

DR. NEUBERGER: This is regarding the California environment, and I'll get into some recommendations I have as to how we can evaluate and enhance portfolios.

I think the California economy, of course, is going to be a little bit stronger than the general economy during the 1980's. A major reason for that is our major industry segments such as defense, tourism, agribusiness, high technology and foreign trade should contribute to a more strong and stable state economy, although I don't think we're going to get the growth rate that we got in the 1960's and '70's because the real concerns about adequate growth policies in southern California, the lack of adequate water. Also I think the reduced speculation of residential real estate --

CHAIRMAN TUCKER: What did you say about water?

DR. NEUBERGER: A shortage of water here in southern California.

CHAIRMAN TUCKER: No, I'm not going to put you on the spot about the Peripheral Canal.

DR. NEUBERGER: I know this is a very controversial issue, but we are in San Diego.

CHAIRMAN TUCKER: Yes, we're in southern California.

DR. NEUBERGER: Just a final comment about Proposition 13. Has Proposition 13 been beneficial to the economic growth or not of the state? I don't think there's any firm evidence that proves or disproves. Economic growth until recently and unemployment in the state until recently I think were lower than they were prior to passage of Prop 13. An awful lot of variables impact here. We do know there's a budget crisis at the state level and you good people know about that. I know Prop 13 has forced some issues relative to budgetary items. Just suffice to say that I think the long-term trends in inflation, economic growth and interest rates will continue to trend toward more favorable positions commencing the latter half of 1982 and as we go out into the latter part of this decade or just a general economic forecast.

Just a comment about state and local government pension funds before we get into some recommendations. Some of these bills that have been presented here, I think many public funds have basically been constrained by inflexibility as far as what they can invest in, how they go about doing that. This peculiar investment behavior I think can easily be explained. However, I think that as long as the behavior is outmoded and is subject to change, and that's why we're having the hearings here.

We have state laws regulating the handling of pension funds, and this is one of the things we're looking at here today. Second, another peculiar aspect of public funds frequently is that the trustees are typically elected or appointed public officials rather than professional investment managers.

Third, public pension programs are subject to review by political partisans whereas private plans are normally private issues. I think that does not create an atmosphere that stimulates innovative or aggressive management of assets.

Fourth, some public funds, of course, have been forced to be captive buyers of employing government bonds. That was certainly the case in PERS in its early history. We know in the 1970's what happened in New York City. They were forced to invest their funds in low-yielding tax exempt securities which were high risk. So you can see the danger.

The fifth reason of peculiar behavior of government pension funds such as PERS and STRS is that employee contributions are put into the fund as employer contributions. So the state's investment policies have a much more severe effect on the public fund than the private fund because of employees contributions in the fund.

I would like to note that state funds around the country are becoming much more well managed than they used to be as managers show what they can do. More professional advisors are put into managing those particular funds. As was mentioned by the previous witness, as far as funds in 1979, public pension funds on an average had 18 percent of the monies invested in government securities, 24 percent in stocks and 48 percent in bonds. Whereas private funds were much more heavily involved in equities with 57 percent on an average invested in equities whereas only 24 percent in public funds.

I mentioned there's a lot more flexibility with private pension funds management than there has been with public pension fund management.

Let me just briefly mention several other reasons why you ought to have superior pension fund management practices. One is the search for mispriced assets. The previous witness talked about buying and selection of assets. Evidence has been pretty well proved that when you are a large fund like PERS and STRS and you're trying to use fundamental analysis and/or technical analysis to find "good buys," that it doesn't always prove out. That is, research expense normally does not pay out. The net return is actually less as you create a major overhead as far as management funds, hiring additional analysts and portfolio managers.

The second reason for inferior performance is overdiversification of funds. I was looking at the PERS annual report for 1980 and I noticed that they had 124 different common stocks, 4 convertible preferred stocks and literally hundreds of different types of maturities of fixed-rate bonds, government and corporate bonds. Now, that would be referred to as overdiversification when you're talking about a fund that has $15 billion in it which PERS did as of this year. You would call that superfluous diversification.

I'd like to show you here in a graphic which is also in my written testimony here. What happens is I call it "Naive Diversification." This is total risk on the Y axes and number of securities on the X axes and through random diversification like throwing darts on the board, as you get eight to fifteen assets into your portfolio, randomly selected, you damp out what is referred to as the stock risk of the fund. That is the forecasting risk that we bought or sold properly priced assets. By the time you get to about 25 securities randomly selected, what you're left with here is called the systematic risk or the beta of the portfolio. Well, as I mentioned with PERS as a case in point, they have many, many more assets than that so the chance that they're going to buy a mispriced asset and be able to generate a superior return is almost impossible over any extended period of time. Too many assets.

CHAIRMAN RUSSELL: What you're saying is that the close attention to the management of those assets diminishes the excess return you might get, and the more you get, the greater the administrative low, the more chance for mistakes and the greater cost of managing that kind of a portfolio.

DR. NEUBERGER: Yes, Senator.

CHAIRMAN RUSSELL: That would apply then as Mr. Stirling just indicated to me, would it not, to this venture capital, the proposal to include the venture capital aspects of the portfolio?

DR. NEUBERGER: It would from the standpoint that investing in those sort of ventures represents such a small percent of the portfolio. I would think in general the benefits would not exceed the cost for a fund of that size. The idea sounds good. But I'm not sure that the benefits you seek are attainable with a fund of that size.

CHAIRMAN RUSSELL: Mr. Elder, do you have a question?

ASSEMBLYMAN ELDER: Yes. Aren't you also saying that what in effect happens is that we're having -- how many did you say, 100 stocks?

DR. NEUBERGER: 124 stocks.

ASSEMBLYMAN ELDER: It's possible to manage that number as opposed to actively looking at 40. I am frankly of the school that we shouldn't be in a stock market. I think the stock market is a disaster for anybody. I think the premier investment in California would be California real estate. Had we done that we wouldn't be having this meeting. We'd be declaring dividends and everybody would be doing a lot better.

DR. NEUBERGER: There's some testimony that would probably counter what you said there, but let's go on. I agree with you to the extent of what you said.

CHAIRMAN RUSSELL: You agree with him?

DR. NEUBERGER: No, that I would counter the fact that it shouldn't be in equities at all, but I do agree with the fact you get into this superfluous overdiversification and you can't keep track of it. To tie that in, another reason is that the funds become too large. The equity funds and even real estate funds, they become so large you create an economy of scale and what happens there is you create instability. For example, if PERS decides to make a major shift in a stock widely known like IBM, decides to buy yourselves 20,000 shares through a block trade or a firm that's a lot smaller would probably be a better example. By the time you decide to make a major commitment into that stock, the effect is it drives the stock price up. If they decide another stock seems to be overvalued, they decide to get out of it, but the time to get out of the stock they tend to drive the price down. So what often happens is the asset that they bought when they thought it was undervalued, by the time they're totally committed, it's overvalued. By the time they get out of it it became undervalued.

CHAIRMAN RUSSELL: But that's short-term and the pension systems really aren't in business for the short-term. Doesn't that wash out?

DR. NEUBERGER: That's why I'm suggesting that they ought to be passive managers of equity funds because they have not been successful in trading on time. I agree with that point.

ASSEMBLYMAN ELDER: Is this the part where you're telling us we should be in the stock market?

DR. NEUBERGER: We're leading up to that and not totally, by the way.

Another reason why the inferior performance that I've seen is the tendancy for funds to not effectively use macroeconomic forecasts. I've listed a lot of those factors on page 14. I won't get into that. Forecasting Gross National Product interest rates and inflation, et cetera. Everybody agrees you need to know what's going to happen before it happens. But the evidence has been pretty well demonstrated that major managers of funds, mutual funds, pension funds have not normally been successful in utilizing economic forecasts. Once they commit themselves to a position, whether it's a bull market or a bear market, they still invest in those securities.

CHAIRMAN RUSSELL: Do you have a recommendation in that regard or is that just the way life is?

DR. NEUBERGER: Well, the key is that my view is that the funds of a major size, they need to be more passive investors and I'll list specific recommendations on that.

CHAIRMAN RUSSELL: In other words, buy something and just hang onto it?

DR. NEUBERGER: Look on a long-term buy and hold basis. Once your accounts have all been reviewed periodically as to the economic performance of the assets, but you don't make major moves toward trading of that asset.

CHAIRMAN RUSSELL: Miss Moore.

ASSEMBLYWOMAN MOORE: Let me ask you something. You've kind of tap danced all around some direct questions on what we ought to be doing with the state pension funds. I'd like you to be a little more specific with me. We talked about the housing industry and you point out, as we all know, that one of the direct impacts on the Gross National Product, of course, is the housing industry. Dave suggested that we ought to be investing in California real estate and we wouldn't have the problem that we now have with our pension systems. You indicated that you did not want to counter at that particular time. I think that's one of the real interests that this Committee has is what we ought to be doing in the housing industry and you keep going all around it and not being very specific in what you think. The caps that you're putting on what we do, I'm beginning to believe that you think we ought to be doing just what we're doing now and that's nothing in terms of being able to capitalize on whatever is necessary to be able to make our position more solid.

So I'd really like to see you speak to more of that. You're taking us down a path that leads us where we already are. I'd like you to hurry up and get there and, if not, I'd like to get some directions.

CHAIRMAN RUSSELL: On that point, are you giving us some sort of a background overview and then you'll come in with some specific recommendations and with those recommendations specifically address the questions that Miss Moore has been asking and Mr. Elder?

DR. NEUBERGER: That was my intent to do it that way.

CHAIRMAN RUSSELL: Then unless the Committee objects, will you continue on your testimony if it will address that issue and then any questions that have been unresolved, Miss Moore, Mr. Elder or anybody else will continue to question you.

DR. NEUBERGER: Okay. Fine. The reason it seems to be complex is that there are a number of questions that I was asked to evaluate and, obviously, trying to make it succinct is what I'm trying to do. I'd say the questions are being generated as we're going through the background. But I will get to those. If I don't, please pose them back to me here at the end of my testimony.

One of the major ways I think to enhance portfolio performance -- I think that's one of the major concerns I think of all pension plans -- is to, and I recommend this particularly with PERS and STRS and all local funds, is they need to spend a significant amount of time in reviewing questions of pension policies, from asset allocation to actuarial techniques and assumptions to benefit design. We talked about the unfunded liability of pension funds. Here in the state of California pension funds are $29.3 billion. I think a couple of the reasons why we had this increase in unfunded pension fund liability in all

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California funds is, one, the actuarial function turned out to be not realistic. Second, the rate of return on the funds turned out to be not as good as anticipated. For example, in the actuarial interest rate assumption for PERS is currently six-and-a-half percent. Nine percent is the highest in, I think, uses. One of the problems you see as an example with Social Security, we've seen a great increase in unfunded liability of that fund. As benefits, real benefit levels have increased and, therefore, the fund for the unfunded liabilities have increased. One of my concerns is that as a pension fund we can establish a goal to achieve a floating real rate of return instead of a fund that's on a fixed rate of return. Evidence has demonstrated that based on a fixed rate of return goal the funds ought to have 60 percent in equities and 40 percent in bonds. That's a fixed-rate of return. My view is it affects inflation which considers a real rate of return which is floating, and I want to present here some evidence from data supplied to the Frank Russell Company relative to what that might be over different holding period.

Okay. This chart shows stock and bond returns compared to the Consumer Price Index over 10, 15, 20 year holding periods.

CHAIRMAN RUSSELL: For the Committee, this is Chart 3 just following page 22.

DR. NEUBERGER: They're going from 1952 to 1979. Okay. Now, this is using the Standard and Poor's 500 stock index as a measure of performance in equities. Now, this would include dividends. This shows over a five year holding period. For example, 1952 to '57, '53 to '58, et cetera. That in 72 percent of the cases equity exceeded the Consumer Price Index. Over 10 year holding period such as 1952 to 1961, et cetera, it exceeded inflation 85 percent of the time; 15 year holding period 94 percent of the time; 20 year holding period, 100 percent of the time. Equities exceeded inflation for 20 year holding periods.

Now, contrast that with the next chart and I have this for my illustration here. If you invested in Standard and Poor's High-Grade Bond Index which is the blue line down here, in 54 percent of 5 year holding periods bonds which included interest exceeded inflation. Over a 10 year holding period it dropped to 48 percent. The interesting thing here is even out here on a 20 year basis bonds only 57 percent of the time equalled inflation. In other words, it did not get better by age.

Now, there's an argument that if you actively manage funds, that you get a better performance if you go about lengthening or shortening the average maturity of your portfolio to take advantage of interest rate swings. So we took here then the results of three bond funds that were in existence over this 1952 to '79 period and over five year holding periods these three bond funds exceeded inflation 63 percent of the time. But over a 20 year holding period it went on back down to 63 percent of the time. The idea being here that even actively managed bond funds did better than the S and P Index as far as bonds but they did not get better as we got into longer holding periods.

CHAIRMAN RUSSELL: On that point, that runs contrary to your passive management statement.

DR. NEUBERGER: As far as equities go. I didn't mention bonds.

CHAIRMAN RUSSELL: Okay. That's a different ball of wax.

DR. NEUBERGER: Okay. The third line up here, the green line represents 110 percent of the 90 day Treasury Bills as an indication of short-term investment. The reason why I use 110 percent of T-Bills is that you can invest in such things as commercial paper, negotiable certificates of deposit which generate a little higher return. The results here show that over one year holding period short-term securities exceed inflation 75 percent of the time; five year holding periods 76 percent of the time, and over the 20 year holding periods it also exceeded inflation 100 percent of the time. Granted, the CPI in my view, of course, overstates inflation.

The interesting results of this chart, as far as the pension funds go, a long-term buy and hold in equities and short-term securities was superior to any fixed-rate assets such as a bond. Now, the question is: how much better? This is where the next chart comes in. This is inflation-adjusted returns, again, 1952 to 1979. The Standard and Poor's 500 Index in one year holding periods generated inflation adjusted returns of 7.2 percent above inflation, four year holding period 6.1, and ten year holding period, 5.1 above the CPI.

The high-grade bond index, one year holding period, a negative return of 1.5 percent ahead of inflation minus .9 percent for four year holds and a minus 1.2 percent for a ten year hold. Now, they actually traded bond funds. They generate a slight policy return of 1.4, .7 and .7 in ten years. The T-Bill rates .2 in one year, .3 in four years and .6 percent in ten year holds. Now, as previous figures have brought out, equities are a lot more volatile than are fixed-rate assets. We need to look at the variance of that --

CHAIRMAN RUSSELL: May I ask a question? On your T-Bills it seems to me that when on a one year basis -- I probably don't understand this -- but on a one year basis when they were getting 14, 15, 16 percent on your T-Bills, how can that not exceed a one year experience in the best equities you have?

DR. NEUBERGER: Remember, Senator Russell, this is an average of one year holding period and I grant you down to the last year or so that 110 percent of T-Bills generate returns on average better than the S and P 500. This is an average of one year holdings over the period '52 to '79.

CHAIRMAN RUSSELL: Thank you very much.

DR. NEUBERGER: And I'll update that in 1980 in just a moment.

What's the risk in investing in these assets? Again, I have not looked into real estate. Here is the variance. Standard and Poor's 500 Index varies on a yearly basis 19.6 percent; ten year basis, 6 percent; high-grade bonds, 7 percent and 1.4 percent, three bond fund average, 12.3 percent and 3.2 percent. Interesting thing is this, if you'll recall from the previous chart. The S and P 500 average return ten year holding period 5.1 percent above inflation. The three bond fund average, fixed-rate assets, .7. However, the variance, you see that, the variance of the high-grade bond is about 50 to 70 percent of what the equity return was. The equity returns were much higher, that is, about nine times higher and the variance of the fixed-rate bonds were about 50 to 70 percent of the equity returns. Of course, again, this is over a period of '52 over to 1979. On a risk-reward ratio, bonds of course do not generate superior returns above inflation, yet they were almost as volatile over these holding periods.

CHAIRMAN RUSSELL: If you take the same period time frame and move it up starting with, let's say, 1975 and you project that out for the same period of time, with those figures, looking in the future if we can do that, if we continue to have higher inflation, 10 to 15 percent, would that still be true or would your T-Bills improve over what you show in history?

DR. NEUBERGER: The T-Bill rate relative to inflation would be a little bit more positive in the last several years. The equity returns would be slightly less. However, the variability of the bonds would be even greater. So all we're really showing here is equities as well as short-term securities would have higher returns and less variance over extended periods of time.

CHAIRMAN RUSSELL: Even with the high inflation?

DR. NEUBERGER: Even with the high inflation.

CHAIRMAN RUSSELL: Would it be better than the T-Bills if we maintained a higher interest rate?

DR. NEUBERGER: Well, between 1960 to 1980 the average rate of return on T-Bills and equities on average have generated a zero real rate of return on average. However, when you blend them into a portfolio mix, you enhance significantly the probability that you will give even a higher return of inflation which is a concern of a pension fund. Let me show you that, Senator Russell. Certainly a pension fund such as PERS and STRS is trying to determine that they want to get a certain rate of return above inflation. This chart shows that over five year time horizons, first off, 1972-'75 that over at this point if you wanted a 2 percent target rate of return above inflation, you're investing only in short-term securities here and no equities. As you increase the percent of your portfolios in equities based on the Standard and Poor's 500 Index, you increase significantly the probability that you'll generate a real rate of return of 2 percent. In fact, it shows when you get to about 50 percent of the portfolios in equities and short-term securities, you increase the probability to about 70 percent that you'll get a rate of return of 2 percent over five year holding periods by having 50 percent in equities and 50 percent in short-term securities. In other words, not having anything in bonds which was my previous conclusion. Now, you can see scaling down here if my goal is a 3 percent real return, a 4 percent real return and a 5 percent real return, that of course mandates I'm going to have to have a bigger percent in equities relative to short-term securities. The probability that I will achieve those rates of course do decline. They do decline. But the key is that I'm going to penalize the fund if I have not had at least 50 percent of my funds in equities to make a general statement there.

Now, the question said what happens in 1980. Let's say my goal was still a 2 percent rate of return. In 1952 and '79 I would have had this mix of stocks and short-term assets to get a 2 percent rate of return over a five year holding period. 1968 and 1980 which is an update -- of course you know equities performed less successfully and, therefore, the probability that I would get a 2 percent rate of return was less than the previous experience. But it's still shown that if I increase my blend in equities relative to short-term securities, I increase my probability of getting at least a 2 percent real rate of return which is one way of reducing the unfunded liability until I get to about 50 to 60 percent of the fund in equities.

The T-Bill, even though the T-Bill and stocks generate on an average a real rate of return which is zero per year, as I increase the percent of my assets in equity, you increase the probability that I could get a floating rate of return above inflation.

CHAIRMAN RUSSELL: A couple of questions before you proceed. Miss Moore.

ASSEMBLYWOMAN MOORE: Going back to that then, let's tie that back to the bill that we have before us. Then you would say that the 50 percent is just, at least 50 percent could need to be maintained as it is?

DR. NEUBERGER: At least 50 percent in equity. I think we should gradually move that direction. I think any fund that has less than 50 percent is paying the penalty in the form of a lower return.

ASSEMBLYWOMAN MOORE: So just give me what 40 percent would do.

DR. NEUBERGER: Okay. The goal, of course, is what is our goal, what rate of return above inflation. Typically let's say it's 2 percent. This would suggest you get a 2 percent return that I would plot out here at least a 50 percent return had to be in equities. If my goal is a higher return than that, like 3 percent, then probably I would have to have like 60, 65 percent in equity, but at least 50 percent over a five-year holding period. That's a concern that I have. A pension fund, of course, can afford to be a long-term profit maximizer without undo concern for short-term liquidity. So, as I showed, of course, equities are more volatile than bonds. But because employers are making contributions into the fund and you're getting returns before dividends and interest, that is sufficient for your liquidity needs. So you can afford the shorter term volatility that are inherent in equities inherent in real estate.

As we show here again, the fixed-rate assets on an average have been less than inflation. As Dr. Shulman pointed out, I'm not extrapolating inflation. I'm trying to accelerate rates as it was in the last three or four years. But I do think that financial assets, simply equities and short-term securities and eventually real estate equities will generate returns greater than financial assets such as long-term bonds even though you may have a lower inflation rate which I hope we do.

CHAIRMAN RUSSELL: Mr. Elder.

ASSEMBLYMAN ELDER: Doctor, I guess you're aware of -- was it a constitutional amendment in 1966 that set a limit as to what percentage of our assets in PERS could be in -- and I think that percentage, if I'm not mistaken, is like 25 percent; isn't it?

DR. NEUBERGER: 25 percent.

ASSEMBLYMAN ELDER: I got here late and I don't know San Diego very well and I've been looking for a parking space for two days. But we've got an incredible number of bonds. I think it's something like $5 billion worth of bonds in PERS last time I looked. We can't very well get out of those because they've all been discounted off the current yield. So we don't really accomplish anything by selling them except we depress the bond market further than it's already depressed. We could do it in one transaction and sell it all at once and minimize the damage we do to ourselves. But how do we get from the position of -- first off, is that a good idea and I must tell you that I am not a fan of the stock market from an investment point of view in exercising our fudiciary responsibility as you've probably gathered from my statements so far. What would happen if we kept it at 25 percent and we went all the rest of it in government paper? The government paper has got to be a primo investment since they print our currency and give us a chance to get out of it at some point.

DR. NEUBERGER: Well, this chart is an indicator that, again, the goal is what is our real rate of return in the fund above inflation. If our goal is 2 percent rate of return, then it would show that by having 25 percent in equity, the rest not in bonds but in short-term securities as T-Bills that it would enhance significantly the probability that you would get a 2 percent rate of return. But it's still what we call suboptimal. You've got to get a great percent in equities.

ASSEMBLYMAN ELDER: How do we extricate ourselves from the position of having $5 billion in bonds? That is a very serious problem. I supported a bill, AB1347, in its first version where the bonds would be used as collateral for loans and we would collect a fee for doing that as providing a security. That was met with incredible shreiks of horror from the retirement community.

CHAIRMAN TUCKER: Including me.

ASSEMBLYMAN ELDER: Actually we amended the bill and got it signed and today I don't think they've made one real estate loan.

CHAIRMAN TUCKER: No. We had a meeting in Daly

City and that was indicated to us that they hadn't. When you're talking about 15 percent money, that's not competitive or 16 percent money. This is what they're talking about. If they had a lower rate of interest, they probably could have moved some of that money. But it was the same money as we're getting from the savings and loans today and that's the reason it hasn't moved.

ASSEMBLYMAN ELDER: Are you saying it hasn't moved because they haven't put it into it or people have not asked for loans?

CHAIRMAN TUCKER: I don't think people have asked for loans. I think you can get cheaper money on the outside than you can from a retirement system that you have a vested interest in.

ASSEMBLYMAN ELDER: With 5 percent down didn't help that a lot either in terms of that mortgage.

In kind of summary here, I think you're leading to a point which I'm extremely interested where you're leading to. But if you could make recommendations in terms of our Board. I think on of the things I've heard you say is that we would be diversified, but not to diversify into 114 stocks. That would be one of the first things you'd say is you can't provide prudent management to that and different investment vehicles.

DR. NEUBERGER: Right.

Let's go right down the recommendations on page 27 and we'll get my recommendations and conclusions and answer any questions that you have and tie that into your comments, Assemblyman Elder.

These are just some preliminary recommendations. It's really not all inclusive. I think one thing we could do is increase the flexibility of both public retirement program trustees as well as fund managers to meet the needs of fund sponsors, fund recipients, fund managers and actuaries. Also, of course, incorporate safeguards to insure a well balanced and adequately protected public investment plan.

There's a bill by Assemblyman Stirling that goes beyond the Keene bill which basically says that you should not have all these restrictions in what you invest in. My view might be to say simply: this public pension fund is permitted to invest in any lawful, prudent investment with a long-term viewpoint. The reason I say that is a fund can be very conservative, but not prudent. The evidence suggests here that by historically investing in long-term bonds which was deemed to be conservative did not turn out to be prudent, meaning to generate returns less than inflation. So my view is it really should be with a long-term viewpoint in mind. Being prudent is to get a return in excess of inflation. We need to break down the obsolete rules on that.

ASSEMBLYMAN ELDER: Mr. Chairman, on that point, for example, what you're saying is by being in bonds such as Penn Central bonds or like Lockheed bonds or Chrysler Corporation bonds, that is considered a very conservative investment vehicle, but in the sense of the current corporate condition of those entities, that is not a prudent investment. Is that what you mean?

DR. NEUBERGER: That's what I mean.

Okay. The second recommendation is a major way to attract and attain a high level of expertise on retirement boards is to adequately compensate them for preparation time as well as meeting time. Also I would think you have to consider possibly making board seat allocations to be reconstituted to attract people with a variety of expertise in setting pension plan policy and as much as possible depoliticize the process and get two experts on the board.

CHAIRMAN RUSSELL: On that point, would that indicate that the various public employee associations should not necessarily then be represented on those boards unless --

DR. NEUBERGER: I think all major parties need to have at least a major representative on the board. I think the key is that in the long run we're all interested that our benefits are going to be covered. So I think the board needs to be weighted in such a way that a variety of expertise is provided in addition to the representation of the employees which I think is important. I think we need to make sure how the recommendations are made, whether the Governor appoint as he does from a very small group of people that are given to him that are conceivably experts in banking or money management. We ought to reconstitute it so that we get a good balance of people on that board and it's not inflexible and it is responsive to changes in investment policy.

CHAIRMAN RUSSELL: Well, two experts on one of the boards, banking would be the best expert, I guess, and insurance might be the next best expert, the Governor has failed to make appointments I think until recently. So those have been open and have created some sort of a hardship. But I think basically most of your appointees come from the associations that are involved in the fund and probably many of them or most of them do not have that expertise. So that recommendations would I think of necessity rule out that type of a person unless there would be just a few representatives of the public and then the rest would be these so-called experts. Assuming that could be done politically, and I'm not sure that it could be, do you think that could be a wise move for the benefit of the fund?

DR. NEUBERGER: I think, again, employees should be represented on the board. Maybe the board could be slightly expanded. But I think the investment subcommittee of the board administration, for example, PERS, should be heavily weighted with various expertise with financial backgrounds.

ASSEMBLYMAN ELDER: Mr. Chairman, on that point, I think that if we were often fond of quoting an expert was somebody from out of town, and Truman had to use an expert was a score under pressure, but if I could say what I think you're talking about here is maybe a technical advisory committee that would be advisory to the full board, maybe one member of which would be a representative of that. That way you could get a mix of Wall Street types and banker types and insurance and so forth so we get a total mix of opinion and expertise so that we can get some good input into a board which may be politically or not politically constituted.

CHAIRMAN RUSSELL: That's probably a good suggestion.

Mr. Tucker.

CHAIRMAN TUCKER: I can't see how you can depoliticize this whole issue. There is really no way. We're talking about a tremendous constituency of public employees. We're talking about people who worked for municipalities and counties in the state of California, all political people, highly political people. I am of the opinion that those people should be represented on any decision making, on any policy making board that is going to deal with their funds. Their whole lives are invested in that retirement system. There's no way you can satisfy me without putting somebody who is interested in that fund, the labor movement or some of the retirees from that fund or somebody who's expecting to retire. I think they should be represented and have input and not only to be an advisory board but they should be on the policy making committee.

ASSEMBLYMAN ELDER: Well, I'm saying whatever the composition of the board you're talking about, that there might be subcommittees made up of technical advisors that would just be advisory to the board constituted with the public employee representation.

CHAIRMAN TUCKER: Fine.

CHAIRMAN RUSSELL: I think that's what PERS now has. They have investment management. We'll have them comment on that when they come up later.

DR. NEUBERGER: Okay. A third preliminary recommendation is that funds such as PERS and STRS should gradually increase their asset allocation into equities to at least the 50 percent levels.

CHAIRMAN RUSSELL: Would you recommend that this bill be changed? Yes, I guess you did recommend that.

DR. NEUBERGER: And I would agree that fixed-rate bonds last year was a great investment. I would recommend that the fund in the near term get out of those. I think the long-term evidence has proved -- this goes clear back to 1920 in the depression as well as prosperity period. Fixed-rate assets normally have not generated a real rate of return. My recommendation is go careful with this. Obviously bonds in the last month or two have been a great opportunity to make capital gains with high rates of return. I would caution if you think you're going to lock in on a 17 percent bond, everyone of those bonds have call provisions. Historically not callable for the first two years or five years. Then they're going to be called away from the fund. So don't assume that we can put all our money into the six to eight or ten percent bonds, that it would be a good idea and that you're going to be able to lock that return in.

Those bonds are going to be callable in general.

Also I consider that the fund ought to put more of the money in short-term securities such as 110 percent T-Bills, such as commercial paper.

The fourth consideration is that large firms such as PERS and STRS should consider writing CALL options against their existing equity portfolios in order to enhance return and reduce the risk, writing CALL options against their portfolios.

Fifth, consider reducing the size of such funds as PERS and STRS into smaller amounts either managed internally and/or externally. As I brought out, equities are better than anything else, but I don't think these large funds have been able to demonstrate superior forecasting abilities in light of their huge size and superfluous diversification. The reason I say that, if you look at the next chart in your outline, here is again using PERS as a straw man, so to speak. This is a percent annualized time-weighted rate of return over different holding periods. For example, PERS equities between December '71 and 1980 generated average returns of 5.2 percent. That's not adjusted for inflation. The Standard and Poor's 500 Index which is for passive investments, their rate of return annually over that period is 8.5 percent. Now, over the last five years PERS returns 14.5 percent per year and the S and P 500, 17.6. The reason we use time-weighted returns here is to adjust to the fact that funds pay more money in during the year investing into the funds. So in order to take out cash flows in the timing, they use what's called time adjusted rate of return. If you want to take into account the new cash flows coming in during the year and the timing, then PERS returns,'71 to '80, 6.9 percent which is still a lot lower than the S and P 500 in percentages, and 14.1 percent versus 17.6 percent with the Standard and Poor Index which basically means --

CHAIRMAN RUSSELL: We're going to have to move along a little more rapidly.

DR. NEUBERGER: I understand that.

Finally what happens, there's another chart here, the last page of your outline, is that they measure the equity returns of PERS using the beta factor of 1.02. That is the volatility of the stock through the market and their average volatility is 1.02 and the S and P 500 by definition has a volatility of 1. When you look down here at column number 11 which is the implied rate of return, here for a five year holding period or one year holding period PERS expected return is 15.9 percent. The S and P 500 which is slightly less volatile is going to return at 16.2 which means slightly better.

Effectively what I'm saying here is we have beta as a measure of the X axes and returns on the Y axes. PERS has beta of 1.02.

CHAIRMAN RUSSELL: Can you summarize what you're saying? I don't understand any of it.

DR. NEUBERGER: This is an investment lecture here.

CHAIRMAN RUSSELL: What are you getting at there?

DR. NEUBERGER: What I'm getting at is PERS is returning a little bit less than required for the amount of risk they've incurred. That is, their equity fund was a little less than an unmanaged index for the amount of risk they incurred on their equity portfolio.

CHAIRMAN RUSSELL: Okay. I understand that.

ASSEMBLYWOMAN MOORE: Can I ask a question?

CHAIRMAN RUSSELL: Yes, Miss Moore.

ASSEMBLYWOMAN MOORE: I'm looking at your recommendations and a lot of it seems to be based on the expertise which the board has in terms of people. Now, given the political realities that have been discussed here and the possibility of gathering that expertise, what happens to the rest of your recommendations?

DR. NEUBERGER: My view is that there's no doubt that you can get the expertise on the board to meet the recommendations. I don't think that's the strength.

ASSEMBLYWOMAN MOORE: No. My question is that given the political realities and the likelihood of us dumping the current board and bringing on a bunch of experts is nil and without that what happens to the rest of your recommendations?

DR. NEUBERGER: Even if there's no change in the board, taking the recommendations as given would still generate a higher return than they are currently. It wouldn't be optimally resolved, but it would still be a result better than they arecurrently.

ASSEMBLYWOMAN MOORE: But a lot of your recommendations are based upon the expert judgment of the board members. If you have no expert on that board, then how would they carry out the rest of your -- I take it you're for the President's economic recovery program?

DR. NEUBERGER: In general, yes. I would think again that providing advice and counsel, everyone of these funds has outside advisors to recommend to the board. So assuming you have an outside counsel, I presume in general board members have a fair amount of competency as now constituted, they could certainly implement these recommendations. That may not be optimal, but it would still be better than currently.

ASSEMBLYWOMAN MOORE: I guess my concern is if you got to trickle down on the board, then we're going to have a real problem in carrying out your recommendations as presented to this panel.

CHAIRMAN RUSSELL: Well, you're really talking about not an economic theory, but an investment --

ASSEMBLYWOMAN MOORE: I recognize that it's the political posture and it's not necessarily the economic. This thing is based on having a certain amount of expertise on that board and that expertise is not there. The lack of us being able to do that, if they don't have the understanding that's necessary to deal with the selection of the kind of stuff that he's talking about, then how would we get there?

CHAIRMAN RUSSELL: Well, I will ask the funds when they come up to explain to us what kind of expertise they use, how these might be implemented with the existing situation as it presently exists. I would assume that to the extent that the board would agree or understand or the experts agree or understand the recommendations and to the extent that they implement them, your position would be that we would do better. To the extent that we do not implement them we will do less than what you anticipated?

DR. NEUBERGER: Yes.

CHAIRMAN RUSSELL: Mr. Elder.

ASSEMBLYMAN ELDER: I was puzzled by your response relative to the callability of the bonds. PERS is not concerned relative to capital gains, tax consequences of the fund. So why would we be worried about a corporation calling the bond that may be paying 17 percent on a discounted basis and why would a corporation want to do that because they're only paying a nominal rate of what they issued the bonds at? It wouldn't make a hell of a lot of sense to buy the bonds back at a deep discount from what I understand unless it's some operation in the corporate profit situation. Why do we care whether they call them back?

DR. NEUBERGER: You care because you're going to have to reinvest the funds at a lower rate. It's true the corporation may invest some interest that's tax deductible and they could care less whether you own the bonds or not and you're tax exempt. They're still going to have to pay that interest. If they can pay interest at 14 percent as well as 17 percent, they can create a new bond to retire the

17 percent. That's going to save them a lot of interest over the life of the bond.

ASSEMBLYMAN ELDER: You're talking about an issue, you're not talking about going into the market and buying discounted bonds, are you?

DR. NEUBERGER: I'm saying, for example, if you had issued recently a 17 percent coupon bond, they're going to want to retire it. I agree if they issued a bond for 6 percent ten years ago, they will not want to call the bond away.

ASSEMBLYMAN ELDER: So what I'm saying if the board went in and bought those on the market, that would be a much more prudent thing because you'd be locked in for sure at the 17 percent.

DR. NEUBERGER: Right. That's correct. That's a good suggestion. You should not be buying a high coupon bond that have great risk that is going to be called away.

CHAIRMAN RUSSELL: Mr. Tucker has a question.

CHAIRMAN TUCKER: First of all, a question and a statement. That large a pool of money, there's always a lot of special interest as to how it should be invested. The A. G. Becker Company did a 50 year study that showed that many years the portfolio of the private plans outperformed the public plans by 2 percent. But since 1971, the public plans have produced comparable to the private plans. No different than the return on those portfolios. I have a philosophy if it isn't broke, don't fix it. We're doing quite well. We're comparable to the private plans. There are suggestions that we allow the private sector to handle this money, to handle the investments. I can't see any difference if they're both bringing in the same amount of return on the portfolio. I really can't understand the interest in wild investment practices, not going with what we were having now. We're getting the same as in the private plans. A good question that I would like to have answered is, why doesn't the private plans go for something else that will bring in a tremendous amount of money? I don't know the answer. Can you give me an answer? Why do the public plans catch up with the private plan? For the last ten years they've been performing the same.

DR. NEUBERGER: That's a good question. What's happened in the last ten years is the rate of return on both private and public funds have not been very good and they approximate each other. So the question is, again, with a pension fund with a larger term horizon of ten years, 15 and 20 years, would it be worthwhile changing policy being increased in the flexibility of fund managers to move in both sort of assets which tend to generate real rates of return. I think in that case it comes down to the timing process. Probably many of the private funds have not been any better than the public funds in timing their returns. For example, everybody decided in the late '60's, you got to get into equities because equities have done well in the '60's. By the time they got into it they had a stock market decline. Everybody said, gee, you should be in bonds because --

CHAIRMAN TUCKER: But that's hindsight.

DR. NEUBERGER: Hindsight invested more in bonds and equities. You shouldn't go full tilt and make a major change in your portfolio. I'm a great believer in gradualism whether it's moving to equities, moving into real estate or whatever. So I'm not advocating a dramatic change. What I'm saying is increase the flexibility.

CHAIRMAN TUCKER: You're advocating the change of who should manage that portfolio.

DR. NEUBERGER: Not necessarily. It has been proven though if you get too large of a fund, you reduce the chance of stimulating a superior return which is what these charts are showing here. In that respect you could decide to split PERS into several smaller funds, managed internally and/or externally. Then the opportunities to get a greater return would be better because you don't get this stabilization problem I pointed out. When the fund is very large you can't move money around without having a rather dramatic effect upon price. So possible recommendations which I think is one of the others I mentioned here is to get the fund into smaller increments and manage those internally or externally. I'm not saying, for example, that PERS has done a poor job. I'm saying that they're so large and so inflexible that it diminishes their chance to generate a superior performance, but they ought to be into equities more than they are in light of the fact that they haven't generated any superior returns, returns averaging better than investment bonds.

(Thereupon a discussion was held off the record.)

CHAIRMAN RUSSELL: Mr. Kapiloff.

ASSEMBLYMAN KAPILOFF: Thank you. I just have one question.

Has any fund seen fit to in effect follow your proposal that you're laying out here and made their investments on the basis of the mix you're suggesting? If there are funds which have done this, can you give us their names and how are they doing.

DR. NEUBERGER: One fund I have direct knowledge of a private sector fund which is the Bendix Corporation private pension fund. Due to exhaustive analysis, they no longer have any money invested in fixed-rate assets such as bonds. The rest of their basic guidelines are this. They have up to 90 percent of their non real estate portfolio in equities, 10 percent at max in short-term securities with a possibility of adding up to 30 percent of the investment in real estate equities. So everything is in equities or short-term securities, nothing in a fixed-rate asset such as a bond. Real estate equities would be up to 30 percent of the fund.

ASSEMBLYMAN KAPILOFF: How are they doing?

DR. NEUBERGER: They felt -- I don't have the numbers -- but they felt in the last three years they had a significant return above the S and P 500. Now, that's a very short time frame. I don't think you should have harsh judgment of performance unless you see a two or three or four year average. So they've only done that in the last two years.

ASSEMBLYMAN KAPILOFF: This is relatively new. Are there any others with any longer term that we can review?

DR. NEUBERGER: None that have the specific numbers to give you. I do know there are some public funds such as New York.

ASSEMBLYMAN KAPILOFF: The reason I'm asking -- I don't want to waste the Committee's time. This is not a revolutionary proposal. It seems to me the proposal would not be all that new and I'm wondering if we can go back to the market place which is the proof in the pudding and see how that kind of mix of investments has done before we change directions.

Thank you.

DR. NEUBERGER: As a clarification I note on page 8 that a recent issue of Pension World they note that in New York, Ohio, Wisconsin and Michigan either currently or project asset diversification in equities to exceed 30 percent. So there would be an example if you'd like to pursue how well they actually do it.

Thank you.

CHAIRMAN RUSSELL: I think Mr. Kapiloff's suggestion is a good one if you can supply the Committee subsequently with any evidence of funds that are using one or more or all of these recommendations as examples of what you're getting at. That would probably be very helpful.

Would you conclude your testimony, please.

DR. NEUBERGER: This final point. I think you should reduce the unfunded liability of these funds. I would think that, hoping to resolve this discussion, that I recommend a thorough study commissioned by each public pension fund to review past performance and develop careful policies aimed at improving investment performance in keeping with rapid changes expected in the financial markets during the 1980's. That's the real nutshell.

I've tried to stimulate discussions. I think we've had that here and we've taken a lot of time to do it. I appreciate being involved here with the Committee in giving you some of these ideas that I believe might be helpful to the Committee.

CHAIRMAN RUSSELL: Thank you very much for your testimony. It was very thorough.

We will again go out of order because a gentleman has to leave before lunch. Robert Knox, Treasurer and Tax Collector, Alameda County.

Mr. Knox, please come forward as quickly as possible.

MR. KNOX: Thank you for inviting me to your hearing. Taking on Mr. Elder's comments about --

CHAIRMAN RUSSELL: Would you identify yourself, please?

MR. KNOX: I'm Bob Knox and I'm the Treasurer and Tax Collector for the County of Alameda.

Mr. Elder was pointing out that anybody from out of town is an expert. So I'll give you some of my credentials.

I have a bachelor's degree from the Berkeley University. I have an MBA from the University of California. I have 12 years banking experience and I was five years owned and managed my own brokerage firm before I ran for the position of Treasurer and Tax Collector of Alameda County. I do sit on the Alameda County Board of Employees Retirement Association Board. I'm a member of the Finance Committee.

I've come here to speak today basically in support of SCA 21 and the Keene bill, 211. I'd like to point out to start with that I think that where we can look at our past performance from the point of view that the dismal return of the bond portfolios in many of the 37 Act counties, and I must point out parenthetically that there are only 20 37 Act counties which Alameda County is one of 20. Taking in unrealized bond loss, unrealized bond losses, Alameda County alone would probably sit with $50 million in our portfolio which is unrealized bond losses.

At a retirement administrative conference last week the State Controller pointed out that the surpluses, the residual of these retirement associations, were approximately someplace over $200 million. My estimate is around $300 million including Los Angeles County. However, if one looked at unrealized market losses and the amount of monies in deferred yield accounts which, again, are then realized losses, that's probably twice that amount.

I'm very concerned and I'm going to talk to your bill 45 and I'll be talking with you tomorrow, I think, as a matter of fact. I'm very concerned with the fact that the need for these services to support supplemental benefits and healthcare plans for retirees is being affected by the fact of poor investment performance.

I think contrary to what Professor Neuberger said, I think public funds, the retirement association, the retirement boards at least 37 Act are competently managed. I think that, not so much the people on the boards are experts in their field, but I think they're all very conscientious. But more to the point is that all these acts, all these boards to my knowledge have professional investment advisors. The Alameda County Board, for example, has three investment advisors which is $300 million in assets divided among them.

CHAIRMAN RUSSELL: Would you explain what an investor advisor is. Is it the broker down the street or investment house?

MR. KNOX: An investment advisor is someone who is professionally employed to advise us on our investments. They have no control over it. They only advise. They don't execute transactions. There's no gain to be realized by making up transactions. They're employed by us as long as the performance is acceptable. When the performance becomes unacceptable, they're terminated. Moreover, we bring in a firm such as A. G. Becker or Cowen Associates to assess how the investment advisors are doing. So basically we have somebody watching the watcher.

CHAIRMAN RUSSELL: Thank you.

MR. KNOX: So I think the retirement boards are competently managed. I don't think the problem lies in the competency of the retirement boards. PERS and STRS, my understanding it mostly does internal management, but the size of this fund would warrant this. I think again from my working with PERS that I think it's competently managed.

So, again, I think the concern here is with the constitutional amendment that's before us with Senate Bill 211. I think the concern should not be mismanagement from expanding the investment parameters. I think there's enough safeguards at least in local boards to preclude this fear.

I think eliminating the restrictions on not only expanding the stock ownership but eliminating the restrictions is prudent. For example, it's ironic that some of the best stocks are the ones that we can't buy. I was looking at the Wall Street Journal on the way down on the plane today and I was looking at, for example, Digital Equipment which I don't think ever has paid a dividend but has been one of the premier stocks on the New York Stock Exchange. I think Data General is another stock that provides no dividends.

CHAIRMAN RUSSELL: That's a good investment that appreciates, but does not return a dividend?

MR. KNOX: Right. Because basically it's a growth stock. They find that their money is better spent reinvesting in their own company than paying a dividend. So the overall appreciation -- they put their money back in their company and the appreciation shows in the stock price.

Now, I have not watched Digital Equipment over the last year or two, but I think over the last five or six years you certainly look at a stock like that as being a stock in motion, the kind a board should own.

I think at the local level, I think we have, say, companies like Intel which is a premier company. This is a California company. It's a premier maker of semiconductors. They don't pay a dividend, so they would not be an eligible investment. Say, take somebody like Spector Physics which is a premier company in lasers located in the Silicon Valley. All of these companies would be precluded from investment by retirement boards at this time.

ASSEMBLYMAN ELDER: Mr. Chairman.

CHAIRMAN RUSSELL: Mr. Elder.

ASSEMBLYMAN ELDER: Did you read the Los Angeles Times yesterday in the business section?

MR. KNOX: No.

ASSEMBLYMAN ELDER: You know, they're in a declining load right now and I might say that Intel and the whole Silicon Valley is down 7 percent sales for the last year.

MR. KNOX: I'm aware of that. I've read the Wall Street Journal, down on the plane today and it's pointing out the competition that the Japanese are presenting us with the 64 k RAM. I think people who speak after me will not -- you can't look at short-term returns. I think the long-term return is what we're looking at. I'm not saying that we should be investing in these companies. What I'm saying is these companies over time have been good performers, but they've been precluded because, I think, just because of the dividend restrictions because you cannot invest in a company that does not pay a dividend.

My real point is that some of the best companies are companies that don't pay a dividend because they can reinvest their money better --

ASSEMBLYMAN ELDER: You weren't making any specific recommendations?

MR. KNOX: I'm trying to keep it brief because I know the testimony is going to be lengthy here.

I think in the area of venture capital the one percent limitation of privately held firms I think -- one needs only look at the Regents of the University of California and my understanding is in talking to those gentlemen that they've been very pleased with investing in the venture capital situation. They've had very, very premier returns on those. Again, venture capital investing allows us to invest again in small companies in California that basically contribute to the overall wellbeing of the economy.

CHAIRMAN RUSSELL: In your opinion does that in any way conflict with the fudiciary responsibility of the trustees, --

MR. KNOX: No.

CHAIRMAN RUSSELL: -- venture capital investments?

MR. KNOX: No. I don't see where it would conflict unless a retirement board member with a -- I just don't see it. Certainly we wouldn't invest in a firm where a retirement board member was involved in.

CHAIRMAN RUSSELL: But a "prudent man" rule relates not only to confidence but also it relates to the, does it not, general acceptability of the type of investments that these banks and pension funds invest in?

MR. KNOX: Right.

CHAIRMAN RUSSELL: And where some guy may have a brilliant idea with SYG Widget Company. It's a very risky company. They then invest in that and still be prudent.

MR. KNOX: I believe so. We have looked. There are some -- yes, I believe so.

Finally, and I know of interest to everyone on this Committee here, is on housing. I think the pension funds need a vehicle for investing in more housing type debt. I think what pension funds are really looking for is the ability to invest in equity participation along with a guaranteed return. Something analogous to, say, convertible bonds. I think the Alameda County Employee Retirement Association presently is looking at some housing in the Hayward area where we'd have a guaranteed return comparable to corporate securities and, yet, 80 percent participation in the equity. I think that's the kind of thing we're looking for.

I'm not totally in favor of investing too much of our money in equity housing as such. I think, as Dr. Neuberger was saying, I think that we can be off cycles. Just when it's time not to invest in something, we may run into it. I think there is a need and I think that there is a very strong possibility that investing in real estate, fixed income real estate with equity kickers will work. I think that some legislation that's headed in the direction the legislation before us is would lead that way.

Finally, pages 21 through 24 of the Final Report of the Governor's Public Pension Task Force which I think has just been released or is about to be released there's some discussion about the multiplier effect of putting pension money into the housing market. We used two models. One was the Data Resources Model which is better known as basically a Keynesian model. Second of all, we used the Department of Water Resources, a fellow by the name of Ed Lofting who used the input-output model. My point here in mentioning these two esoteric models is that one corroborated the other. In both cases we found the multiplier of about three-and-a-half times. That means for every dollar put into the housing market, we got out $3.50 back in increased jobs and money into the economy. I think that that's something to make a strong case for getting more pension money into the housing market.

CHAIRMAN RUSSELL: What loss in return or security or safety?

MR. KNOX: As far as the study, it didn't address that. The presumption would be that the money would be invested at market rates. The presumption of the model would be that that money, money invested into the housing market, would be invested at market rates.

CHAIRMAN RUSSELL: I see.

MR. KNOX: That concludes my testimony.

CHAIRMAN RUSSELL: May I ask a couple of questions then?

On the SB 211, do you support the concept that relates to the state Security Advisory Board and their review and the composition of that particular board?

MR. KNOX: I don't have an opinion.

CHAIRMAN RUSSELL: Do you feel that the fund should be limited as it is in SB 211, I believe, to within the jurisdiction of the courts of the United States only?

MR. KNOX: Yes, I do, if I understand what you're saying. Again, I have not studied that section, but certainly I would think the courts of this country should have jurisdiction.

CHAIRMAN RUSSELL: That would preclude any foreign investment if I understand that.

MR. KNOX: To be honest, I'm not real familiar with what the intent of that section is.

CHAIRMAN RUSSELL: Well, if that is true, do you think that's good or bad, preclude the pension system buying stock in a --

MR. KNOX: Personally, I'm a little parochial that way. I feel that we should invest in this country.

CHAIRMAN RUSSELL: Do you think the Legislature should restrict their ability to do that?

MR. KNOX: Yes, I do.

CHAIRMAN RUSSELL: Do you think that's a good thing for us to do?

MR. KNOX: Yes. Given what you told me, yes, I do.

CHAIRMAN RUSSELL: All right.

Any comments that you care to make on the bills that we are considering in terms of their construction? Have you read them?

MR. KNOX: Yes, I've read them. I'm basically here to tell you what my feelings are about the bills and I think what the intent of the bills were in my expertise.

CHAIRMAN RUSSELL: Do you feel that the 50 percent limitation on equity is appropriate or should there be, as Dr. Neuberger suggested, maybe no restrictions other than what is appropriate and prudent?

MR. KNOX: I think there should be no restrictions. I think the "prudent man" is the way we should make our investments.

CHAIRMAN RUSSELL: Do you agree with the way the "prudent man" rule is explained in AB 211?

MR. KNOX: In general, although I'm not an attorney.

CHAIRMAN RUSSELL: Thank you.

Any other questions? Mr. Stirling.

ASSEMBLYMAN STIRLING: Mr. Knox, you are one of the investment advisors of Alameda County. Does it have an independent retirement system itself?

MR. KNOX: I'm not an advisor. I'm a member of the Finance Committee. I think I should explain that one more time.

ASSEMBLYMAN STIRLING: I think I understand. Does Alameda County have an independent retirement system which you help direct?

MR. KNOX: Yes.

ASSEMBLYMAN STIRLING: What is the unfunded liability ratio in the current year?

MR. KNOX: What you're asking is about 80 percent.

ASSEMBLYMAN STIRLING: So of your liabilities you have 80 percent of it funded?

MR. KNOX: Yes.

ASSEMBLYMAN STIRLING: What was your return on investment in fiscal year ending June 30th?

MR. KNOX: About 9 percent.

ASSEMBLYMAN STIRLING: And does your report post its unrealized gains and losses on your portfolio?

MR. KNOX: No.

ASSEMBLYMAN STIRLING: Is there any reason that you know of why the unrealized gains and losses can't be posted other than physically going through and finding what they are?

MR. KNOX: I'd like to answer that with a little bit of discourse. I'm very much opposed to the way the 1937 Act reads as far as handling the unrealized market losses, especially the two sections that deal with deferred rules and what's called in the industry grossing up bond prices in order to hide losses.

ASSEMBLYMAN ELDER: Grossing up bond prices?

MR. KNOX: Well, the method -- and I don't have the code section -- there's two code sections in the 1937 Act which allowed you to in effect swap bonds without realizing the losses. It's vigorously opposed by the accounting profession and by anyone else that basically is knowledgeable about investments.

One method is you take a loss, when you sell a bond you take a loss. You don't realize it. You don't write it off. You just make an asset. Okay.

The other method is called grossing up the bond price is if I bought a bond at a million dollars and I sell it as a loss of a half million dollars, basically I get a half million dollars and I take a loss of a half million dollars, at the same time I buy a new bond for a million dollars at true cost. What I do then, I add the half million dollar loss on the basis of the new bond purchased so in effect I get -- you're shaking your head.

ASSEMBLYMAN ELDER: I understand it, but I can't believe it.

ASSEMBLYMAN STIRLING: Is there anything in the '37 Act that precludes you from reflecting to your beneficiaries a more accurate portrayal of your status?

FROM THE AUDIENCE: No.

MR. KNOX: Somebody else said no.

ASSEMBLYMAN STIRLING: Well, it's been testified again and again that somehow PERS or STRS or anybody else is not able to portray accurately the true status of the fund because of accounting constraints. I'm trying to find a constraint somewhere that says that you can't also portray any other management information or prospective information or background information that you think enhances the understanding of beneficiaries.

MR. KNOX: I want to make it clear that in 7505 or someplace in that, there's a section in the '37 Act -- I also have the government code, the West's Annotated Code. But in the booklet that all treasurers are given there's a little introduction section, 7505 or 7500 series that says that the intent of the Legislature is that there's a fair picture given of the assets of a system. I've had a fairly extensive debate with my own board about their presentation.

To answer your question, the answer is no. There's nothing in the '37 Act that precludes you from giving a fair presentation.

ASSEMBLYMAN STIRLING: I guess the next question is why so many fudiciaries feel a constraint not to add additional representation on their annual financial reports.

MR. KNOX: I can't answer that.

ASSEMBLYMAN STIRLING: Do you have an actuarial update on your fund?

MR. KNOX: Yes.

ASSEMBLYMAN STIRLING: Each year?

MR. KNOX: Yes, we do.

ASSEMBLYMAN STIRLING: You think that's prudent each year?

MR. KNOX: Yes.

ASSEMBLYMAN STIRLING: One every four years is not enough for you?

MR. KNOX: I don't think so. I think that it's well to know where we -- I think when you're dealing with $300 million, I think that --

ASSEMBLYMAN STIRLING: At least once a year would be a good time to find out?

MR. KNOX: Yes.

ASSEMBLYMAN STIRLING: How about if you're dealing with $15 billion?

MR. KNOX: Maybe once a day.

(Laughter.)

ASSEMBLYMAN STIRLING: Thank you. I've just been told by a number of PERS people that they're real leaders in their field and that they're really overdoing it by updating their actuarial studies once every four years and I find that a little hard to believe.

CHAIRMAN RUSSELL: Thank you very much.

Mr. Lloyd Stockel.

MR. STOCKEL: Good morning. I'll try to stay close to this.

My name is Lloyd Stockel.

Presently, I serve as the Undersecretary of the Business, Transportation and Housing Agency. Before I took this position last December, I spent 21 years in the investment banking business, most recently as a partner of Goldman, Sachs and Company. It was in this capacity that the Governor appointed me to his task force on Public Pension Investment Policy.

From my experience in the private sector I am fully aware of the difficulties of managing a large portfolio in today's roller coaster economy of high inflation and wildly fluctuating interest rates. Even with the flexibility given private pension fund managers to invest funds under the "prudent man" notion, it is difficult to preserve the purchasing power of the deferred wages of the millions of workers that these retirement funds represent. When we add to the turmoil of the economy the onerous restraints presently imposed on public pension investment, the performance of the funds is seriously impeded. And with the fiscal squeeze that all public entities -- from local to state to national -- are beginning to feel, it takes little imagination to see the predicament that taxpayer-financed retirement systems will ultimately confront unless investment performance can be improved.

I have distributed separately data showing the overall rates of return earned on common stocks and corporate bonds for selected periods of time since 1927. The most important conclusions that can be drawn from this data are the following:

First, the variation in the rates of return between common stocks and bonds have widened in recent years.

Second, common stocks overall and for most long periods of time has clearly outperformed bonds.

Third, the availability of investment managers to shift from one type of financial instrument to another has become critically important to the goal of achieving satisfactory investment performance.

I might refer to one statistic included in that data which is the return shown for the 25 years from 1954 to 1978 on common stocks of nine-and-a-half percent and on long-term corporates of three-and-a-half percent roughly. I didn't have tables to reflect the precise percentages, but I must indicate to you that over a 25 year period of time at 5 percent a year, compounded annually, $100 becomes $339. At 10 percent a year for 25 years, $100 becomes $1084.

What is proposed in SCA 21 are changes in the constitution that will offer pension managers and trustees greater flexibility in a volatile market, broader authority to diversify their portfolio, and an increased capacity to obtain a hedge against inflation. After consultation with fund managers, the investment community and employees, as well as retiree beneficiaries, we believe that the changes proposed in SCA 21 represent the most feasible and responsible approach to the problem. What this amendment does is to relax the constraints in the constitution while holding fund managers and trustees to a high standard of judgment and responsibility by requiring investments to be made under the prudence rule now used in the private investment community.

These changes signal a move away from the legislative allocation that, while adequate under earlier circumstances, now impairs the performance of public pension funds. With these changes, California will be joining a national trend, as noted a few months ago in the Wall Street Journal. "Around the nation," the Journal reported "more public pension funds are rebelling against the conservative rules that have hobbled their investment options."

In summary, the changes proposed here by SCA 21, which we fully support, increase the flexibility of pension fund investments in a responsible way while insuring the security of the retirement savings of California's public employees.

CHAIRMAN RUSSELL: Do you suggest that the bill's present parameters of 50 percent and 5 percent and 1 percent should be eliminated in favor of an open ended?

MR. STOCKEL: If I thought it were politically feasible to pass in that form, I would recommend it.

CHAIRMAN RUSSELL: So you're in favor of less restriction?

MR. STOCKEL: Yes, sir.

CHAIRMAN RUSSELL: Are you looking at it now from a long history of a person who has experienced the ups and downs in projections and so forth?

MR. STOCKEL: Yes. Twenty-one years.

CHAIRMAN RUSSELL: Do you agree with the statement of Dr. Neuberger about a passive investment policy with the relationship to the equities being better than an active one?

MR. STOCKEL: No, sir. In fact, I think he contradicted himself with performance of fixed income funds being improved through active management. I think the same thing is true in equity portfolios.

CHAIRMAN RUSSELL: He was talking I thought in terms of an active bond management.

MR. STOCKEL: By active management he meant actively buying and selling, and I think he means --

CHAIRMAN RUSSELL: Trading?

MR. STOCKEL: Yes.

CHAIRMAN RUSSELL: And he was relating it to equities and not to bonds.

MR. STOCKEL: To bonds.

CHAIRMAN RUSSELL: Well, he said that was all right.

MR. STOCKEL: He said actively managing a bond performance would improve its performance, but passively managing a portfolio as large as PERS would be better than trying to actively manage it. I disagree with that. I find that inconsistant and I also disagree with it.

CHAIRMAN RUSSELL: All right. Well, I don't know if we want to get into that with the time that we've got. So maybe we can talk about that later so I can understand exactly where you do disagree.

Have you looked at SB 211?

MR. STOCKEL: Yes, I have.

CHAIRMAN RUSSELL: You have any comments as it relates to the questions I asked previously in regards to the State Security Advisory Committee?

MR. STOCKEL: I have no comments on the composition. As I mentioned, I'm relatively new to state government. I do think such a group is needed. I would like to make one point though that I think was not understood by prior witnesses and I hope it is well understood by those of you reviewing this amendment and this bill; and that is that the idea of venture capital investment is not for the public pension funds to search out and find a small venture situation on their own and invest in them. That is not the concept. The concept is for them to become quite passive actually, to become limited partners in venture capital pools that are formed by venture capital professionals which is the way most other pension funds who invest in this area do it.

CHAIRMAN RUSSELL: An investment pool?

MR. STOCKEL: An investment partnership.

CHAIRMAN RUSSELL: Of individuals or a series of these?

MR. STOCKEL: Well, start with one.

CHAIRMAN RUSSELL: Like a mutual fund for venture capital?

MR. STOCKEL: No. A specific venture capital organized by professional organizations, organized and to be managed by that organization, and that's the organization that would make the individual investment decisions as to which venture to invest in, not the retirement system.

CHAIRMAN RUSSELL: How would that work? You would invest into a pool which --

MR. STOCKEL: Which is intended to --

CHAIRMAN RUSSELL: Let me finish, sir, so you understand what my question is.

Are there many venture opportunities in this pool or is this --

MR. STOCKEL: Yes.

CHAIRMAN RUSSELL: And that makes up the investment group so you invest in the pool?

MR. STOCKEL: The pool starts with cash from investors like pension funds and corporations.

CHAIRMAN RUSSELL: And then they invest in several of these kinds --

MR. STOCKEL: A number of venture situations selected by that venture professional, not by the pension fund investor.

CHAIRMAN RUSSELL: So the expertise on the pension system would be determining which pool manager was the best?

MR. STOCKEL: Yes.

CHAIRMAN RUSSELL: It would be similar to evaluating investment managers for a publicly traded portfolio, yes.

CHAIRMAN RUSSELL: And one more question. Do you feel that there should be a limitation in this bill that restricts any investment to the United States?

MR. STOCKEL: I would prefer not to see it. I'm a free market person.

CHAIRMAN RUSSELL: Do you think there's any, for pension funds, safety being a criteria, do you think there's any inherent risk that we should not invest in something out of the boundaries of the United States?

MR. STOCKEL: I think restrictions on investments will almost by definition mean reduced performance.

CHAIRMAN RUSSELL: Thank you.

I think Mr. Stirling has a question.

ASSEMBLYMAN STIRLING: Mr. Undersecretary, do you support the concept in the bill to establish another advisory committee to oversee investments?

MR. STOCKEL: No. I was referring specifically to their function with respect to the venture capital investment.

ASSEMBLYMAN STIRLING: Well, the state securities call them investment boards or advisory boards.

MR. STOCKEL: I thought their function was to review the non-publicly traded investments.

ASSEMBLYMAN STIRLING: Well, the question is why have them at all? Why not leave that fiduciary responsibility in the direct hands of the people that are elected to govern the funds?

MR. STOCKEL: Well, if they chose one, Mr. Stirling. I think that only because it's so new and it does create concerns on the part of a number of people, that may be having an advisory body involved would be a good thing.

ASSEMBLYMAN STIRLING: Well, the problems that I see as we already have so much overhead loaded onto the funds and "surplus energy" which I don't agree with. We have people elected that are the beneficiaries of the fund. We have people appointed from your office and your branch of government and others and we have a 45 percent funded ratio and a return on investment of less than 10 percent. I don't feel strongly, Mr. Stirling, about that group.

ASSEMBLYMAN STIRLING: Does the administration feel strongly about it?

MR. STOCKEL: No, sir. It would be nice to ease the concerns of those who are concerned about going in that direction. To the extent that it might cause undo costs and burdens, I do not think so.

ASSEMBLYMAN STIRLING: Well, it seems to me that they have hired advisors, they have investment committee, they have a professional staff. I'm just wondering why we have to bring into law another advisory group when the state is replete with them. If you say the administration is not firm in that, I appreciate it.

Have you had a chance to look at ACA 57?

MR. STOCKEL: Yes. But I don't pretend any detailed knowledge of that.

ASSEMBLYMAN STIRLING: Well, a substantial difference in ACA 57 is we reduce the amount of constraints on the fudiciary and left them primarily with the "prudent person" rule -- I support IRA -- "prudent person" rule. I thought I heard you say that if you had it your way --

MR. STOCKEL: If I thought it could pass, I would be a supporter.

ASSEMBLYMAN STIRLING: Would you be surprised to find that your recommendation to the Secretary of Business and Transportation and the Governor may have some inputs on that position? If you feel comfortable with that, you ought to recommend that they take that position.

MR. STOCKEL: I have made that recommendation, Senator.

ASSEMBLYMAN STIRLING: Thank you.

CHAIRMAN RUSSELL: I get from your statement on the state's Security Advisory Committee, that while you don't have a problem with it, I feel from what you have said between the lines that really it would not be necessary. The approach would be adequate without it. Would that be fair to say?

MR. STOCKEL: Yes, sir.

CHAIRMAN RUSSELL: But you don't have any problems with it?

MR. STOCKEL: That's correct. And to the extent that it makes those who are concerned about the venture capital part of that amendment uncomfortable, to the extent that it eases some of that comfort, it might be a good idea.

CHAIRMAN RUSSELL: Of course, as Assemblyman Tucker indicated, there is a political process involved in this. But my concern with Mr. Stirling is that we are adding an additional political entity to overlook the shoulders of the trustees, the investment committee and this pool of experts that are venture capital experts and be so mired down in second guessing that we will not let the people who are hired to do that do their job. Isn't that a real possibility?

MR. STOCKEL: I see your point, yes.

CHAIRMAN RUSSELL: Thank you.

We'll have one more witness, Mr. Carl Blechinger unless --

MR. BLECHINGER: If you can get rid of me in five minutes, I'll be happy to.

CHAIRMAN RUSSELL: You have a fairly lengthy presentation? If so, let's do it after lunch.

MR. BRANCH: Mr. Chairman, I have a very short presentation.

CHAIRMAN RUSSELL: And who are you?

MR. BRANCH: I'm Mr. Branch.

CHAIRMAN RUSSELL: Mr. Branch, you'll be next.

MR. BRANCH: Mr. Chairman and Committee, I'm Robert Branch, the County Treasurer and Tax Collector of Ventura County and I'm also the current president of the State Association of County Retirement Administrators which is a group of the treasurers and retirement administrators of the 1937 Act counties.

By way of background, I've been either an employee member or a board member of our retirement system since 1956. So I have some background in terms of the '37 Act.

Our organization which is made up, as I say, of county treasurers, retirement administrators, board members, staff, the whole ball of wax, met in Anaheim on November 5th and 6th at which time we had lengthy discussions on SCA 21 and SB 211. I can tell you now that, without any reservation at all, the association endorses both of those measures.

CHAIRMAN RUSSELL: As is?

MR. BRANCH: As is.

The concern of the group was not so much the approval and the passage of the measure by the Legislature but the importance of mounting an orientation and education campaign to assure voter support when they appear on the ballot. It was a collective opinion that the Legislature was to acknowledge the importance of maximizing the return on the investment of public funds -- this means all public funds -- would be in full support of the concept because the importance of maximizing return on public monies has never been of greater importance than it is today.

Of the 20 '37 Act counties, they all employ professional investment advisors, both in terms of their bond portfolios and their stock portfolios.

CHAIRMAN RUSSELL: Those are firms that are hired strictly for advice, do not invest funds?

MR. BRANCH: Well, actually it's a mix. Some of the firms are advisory, some of the firms are advisory and active portfolio managers. In the case of Ventura County, for example, our investment advisor is also the active portfolio manager of the fund subject to the control of the board.

CHAIRMAN RUSSELL: What is that firm?

MR. BRANCH: Our firm is Securities Pacific Investment Managers Incorporated.

CHAIRMAN RUSSELL: They get a percentage of the investment?

MR. BRANCH: They work on an annual fee basis and it's a negotiated fee.

CHAIRMAN RUSSELL: Thank you.

MR. BRANCH: In the case of Ventura County which I can speak to, it's been gratifying to me to observe the increasing sophistication of our board as they go through the process of setting investment objectives and portfolio asset allocation. To expand on that just slightly, we sit down with our advisors quarterly and on an annual basis we sit down and we review all of the investment objectives, all of the asset obligation criteria and spend at least one full day every year and about one day every quarter in reviewing the investment activities of the portfolio. My board through this process -- and this goes back to the comment made earlier about the possibility of imposing experts on our board, I find that our boards are very intelligent, lively, active, inquisitive and they learn very, very rapidly. They give our investment advisors some very hard times in terms of the kind of questions that they ask and delve into. So I feel really confident in the expertise of our individual board.

CHAIRMAN RUSSELL: Can you tell us very briefly what categories of people are on the board?

MR. BRANCH: Yes. As you know, Senator, the board is made up of employee representatives elected by their peers and by public members appointed by the Board of Supervisors. The employee members generally come from the middle management ranks. The public members, at least on my board, I have one investment banker, I have one banker, I have one businessman and, let's see -- what's the other one? -- Oh, a member of the Board of Supervisors.

CHAIRMAN RUSSELL: Don't forget him.

MR. BRANCH: He is a public member who just happens to be a supervisor.

Incidentally, these board members out of a labor of love have a tendency to stick around quite awhile. You don't have a great turnover in board members, at least in my observation. They're people that have an abiding interest in retirement systems and they develop a great deal of expertise over time.

CHAIRMAN RUSSELL: Did you say most 37 Act county boards have an investment committee of board members?

MR. BRANCH: Some of them have investment committees of board members. Some of them have a committee of the whole. For example, my committee is a committee of the whole.

CHAIRMAN RUSSELL: Which is more prevalent?

MR. BRANCH: I would say probably the committee of the whole with the exception of Los Angeles County which has a separate distinct board of investors.

CHAIRMAN RUSSELL: Thank you.

MR. BRANCH: But we have, or at least I have observed, my board's increasing frustration as they become more and more knowledgeable of the constraints that are imposed in the law. I happen to agree with the comments made by H. D. Alvord at our administrators meeting when he commented that the present law evolved out of a depression mentality. Because, as you'll recall perhaps, originally the 1937 Act counties were restricted to buying municipal bonds only which made a lot of sense for tax exempt bonds. Subsequent to that, they were allowed to move into corporate bonds and buy 1911 and 1915 Act bonds. That's pretty conservative. That's pretty conservative. That to me was a depression mentality.

CHAIRMAN RUSSELL: Did your meeting in support of these bills, did you feel that there should be no limitations as some of the other witnesses have indicated?

MR. BRANCH: No. We agree with the limitations, Senator. We would probably prefer a 60 percent allocation as far as equities are concerned, but we'll settle for 50.

CHAIRMAN RUSSELL: Did you have any discussion or any concern about the issue about the state Security Advisory Committee?

MR. BRANCH: We didn't address that. But my personal opinion is that it would be superfluous.

CHAIRMAN RUSSELL: Right. Mr. Stirling.

ASSEMBLYMAN STIRLING: Thank you, Mr. Chairman.

You're saying that the "prudent man" rule is not a significant enough constraint on your trustees that that would be enough guarantee of safety for the fund?

MR. BRANCH: I'm not so concerned about my trustees, Mr. Stirling.

ASSEMBLYMAN STIRLING: It's the other guys.

MR. BRANCH: I am concerned that, having observed the exposure that perhaps more less sophisticated boards might be exposed to some Oklahoma gunslinger who would come in and sell them a bill of goods.

ASSEMBLYMAN STIRLING: That wouldn't happen to your board or any people that you know?

MR. BRANCH: No, sir. Wouldn't happen to our board.

ASSEMBLYMAN STIRLING: Would you be surprised to find out I don't think it would happen to any of the boards that I know?

MR. BRANCH: Well, I'm very comforted to hear that.

ASSEMBLYMAN STIRLING: What do you think the constraints on a person exercising the "prudent man" rule to be? What is the remedy if they violate?

MR. BRANCH: If he's serving as a fudiciary representative on a public retirement system, it's probably jail.

ASSEMBLYMAN STIRLING: And he or she is entirely personally liable?

MR. BRANCH: That's correct.

ASSEMBLYMAN STIRLING: Any loss that they can show as approximate result of their misdeeds, even their misjudgment.

MR. BRANCH: That's my understanding at least.

ASSEMBLYMAN STIRLING: So where is the lack of guarantee to the fund that is --

MR. BRANCH: I wouldn't call that a guarantee. I'd call that perhaps a punitive remedy. But isn't a guarantee to prevent it from happening in the first place.

ASSEMBLYMAN STIRLING: Well, that's true. But you don't usually have full facing performance bonds with trustees.

MR. BRANCH: No, sir. We do not. Only the county treasurer has that.

ASSEMBLYMAN STIRLING: I think there probably should be.

So you're resting your concern for maintaining a constitutional limitation on a mix of the portfolio which testimony after testimony after testimony shows is the ultimate bugaboo in these public performance bonds. Your concern is that while there may be a punitive remedy for the trustee, there's no guarantee as to the beneficiaries of the fund?

MR. BRANCH: That's right.

ASSEMBLYMAN STIRLING: If the "prudent person" rule was coupled with a requirement for full faced performance bond, could that change your mind?

MR. BRANCH: It could very well.

ASSEMBLYMAN STIRLING: I'd appreciate if you'd keep that in mind as we go along here especially in your review of ACA 57.

MR. BRANCH: All right, sir. Thank you.

CHAIRMAN RUSSELL: Mr. Elder.

ASSEMBLYMAN ELDER: You know, I heard Mr. Alvord at one point go on for, it must have been 25 minutes, reading a statement relative to his interpretation of the "prudent man" rule. I can't imagine a more conscientious or conservative or judicious person in terms of interpreting as narrowly as possible the scope of his responsibilities from the standpoint of not wanting to be liberal with the money. But I think I would like to get your reaction to the possible situation that members of the board be bonded. That seems to me maybe an excellent idea. It isn't going to do much good to put them in jail.

MR. BRANCH: Well, as you know, a bond is there to protect the public. It is not there to protect the person who is bonded.

ASSEMBLYMAN ELDER: Right.

MR. BRANCH: The bond doesn't afford any protection in that regard.

Recently I read some articles where across the country concern has been expressed by trustees of particularly private pension plans of their own personal liability exposure and through the International Foundation of Employee Benefit Plans they're actually proposing some individual liability insurance for board members. But as far as the protection of the beneficiaries of our systems are concerned, I would find nothing wrong with the posting of a performance or fidelity bond by board members. I don't know what the reaction of the individual board members might be to that.

ASSEMBLYMAN ELDER: I'm not saying that they would necessarily have to pay for it.

MR. BRANCH: The system would pay for it as an administrative cost, I presume.

ASSEMBLYMAN ELDER: If you want the ultimate in conservatism, that would be it. We don't care if they're in jail. We want the money.

MR. BRANCH: That's right.

CHAIRMAN RUSSELL: Mr. Tucker.

CHAIRMAN TUCKER: As President of that County

Administrators Retirement System organization, has any thought been given to pooling investments of the 37 Act counties for certain purposes? Have they ever considered that?

MR. BRANCH: I've never heard it discussed, Mr. Tucker, no. They're a pretty independent bunch of people and I think that's the reason it hasn't been discussed.

CHAIRMAN TUCKER: Do you look at other counties' retirements or discuss that at your meetings --

MR. BRANCH: Oh, most certainly.

CHAIRMAN TUCKER: -- and what their rate of return is?

MR. BRANCH: Oh, yes.

CHAIRMAN TUCKER: But they've never considered pooling their resources?

MR. BRANCH: We've never discussed the pool concept at all.

CHAIRMAN RUSSELL: Does that conclude your testimony?

MR. BRANCH: That concludes my testimony.

CHAIRMAN RUSSELL: Thank you very much.

We will recess for lunch. We will try to be back here at 1:20.

(Thereupon the Joint Interim Hearing of the State Assembly Public Employees and Retirement Committee and the State Senate Public Employment and Retirement Committee was recessed for lunch at 12:20p.m.)

AFTERNOON SESSION

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CHAIRMAN RUSSELL: I think we'll start. We're five minutes earlier than the announced time, five minutes later than the hoped for time. So we ought to be about ready to go.

MR. BLECHINGER: Thank you, Mr. Chairman.

CHAIRMAN RUSSELL: Bring it real close.

MR. BLECHINGER: My name is Carl Blechinger. I'm Executive Officer of the Public Employees' Retirement System. This is Walt Williams who's a Principal Investment Officer and he's with our investment strategy unit or what we call a long range planning function of PERS.

I hadn't realized that the discussion would get on such a broad basis this morning, so if it's all right with the Committee, I'll discuss what we had in this paper and then we'll be happy to discuss general investments philosophy or whatever questions you may have.

The Public Employees' Retirement System supports the general principals contained in SCA 21. Essentially the reason is the expanded investment authority that it provides. There have been many studies that show that a 25 percent limitation such as is in the constitution now, and particularly for a fund of our size, is a little bit too limiting. The board did go on record as supporting SCA 21 when it was 60 percent, but the board is not unhappy with 50 percent. The board has not taken a position on whether it should have unlimited authority on investments in common stock. I think the essential reason for their position and the staff position is about the same. It is the fact that politically it is infeasible to try to get unlimited authority to invest equities in the state of California. A number of years ago when the current constitutional provisions were passed, I was very active in that campaign and was very active in the State Employees' Association and very active in that campaign. I remember well the first time that this proposition was proposed to the voters of California. Major newspapers were opposed to it, number one, because of the controls, because they felt there wasn't adequate controls and, number two, because they felt the restrictions on investments were not tight enough in the original version to allow them to support it. They opposed it very vigorously.

I think that my personal opinion is that the supporters of this approach then overreacted and put over-restrictive provisions in the next constitutional amendment that was proposed.

We've indicated for you that PERS is one of the largest financial institutions in the United States. It's running about $15.4 billion in our fund right now. Large amounts of bonds have often had to be purchased in an economic environment when stock appear to offer the potential for much greater total return over many years. This is particularly so in times of high and rising inflation such as we have witnessed in the latter half of the 1970's when the value of bonds and other forms of saving were badly eroded by inflation driven rising interest rates. The values of fixed income investments in bonds and mortgages, as has been previously noted today, -- so I won't go into that -- have been eroded very substantially lately. So in such times the ownership of financial assets like stocks have a better opportunity to adjust to inflation than other forms of lending ordinarily provide.

So we suggest essentially on SCA 21 that that portion that eliminates the 25 percent restriction is advisable under these conditions.

I've noted for you on page 2 -- and I won't go into this unless the Committee wishes to because it was alluded to earlier -- a study by the University of Chicago by Ibbotson and Sinquefield about the return of stocks in the New York Stock Exchange over a 50 year period. Quite frankly, as a semi-layman I guess you could say in this area, I'm not too impressed with going back looking over a long period of time like that because of the nature of the economy and the world that we're living in today is substantially different than what has happened over such a long period of time. On the other hand, the historians might say that in order to get some feel for what the future may have in terms of the common stock or equity in bonds, that you need some type of approach of that type.

Not surprisingly common stocks showed much greater volatility of returns than bonds. However, bond volatility of returns has risen considerably in recent years. So if you note that over the long run actually the stock prices and the investment of stocks has taken into account the relative higher risk of investment in equities.

The type of investors most able to accept this generally higher price volatility of stocks and to benefit from the higher long term returns that stocks have historically provided are those of relatively stable and predictable cash flows. Those investors will not need to sell in adverse markets to meet required payments. Adequately funded pension funds are ideally suited to be such long term investors. If you are noting, one of the speakers this morning was talking about passive investments. We don't feel that we have a passive investment in-house. We do have a situation where we don't buy and sell perhaps as quickly as some other investor interested in a quick profit or a capital gain over a limited period of time do. But we don't feel that we are passive investors in any sense of the word.

We've noted for you that the average stock holdings of corporate pension funds are about 60 percent of assets at market. PERS of course is roughly half that level at 25 percent.

Another provision of SCA 21 would allow investment of up to 5 percent of assets in the so-called venture capital. This primarily is to allow us to get around the current restriction in the constitution where the firms must be a fairly large size, have a long history of dividend payments and meet a variety of many other critical requirements. But many younger companies do not fit into this category. They are found in higher technology areas and over longer periods these companies have generally provided investors with higher total returns than larger and more mature companies. Of course, we have a substantial number of larger more mature companies in our stock portfolio. The added risk can be largely diversified away by proper portfolio construction. Some parties have commented that the additional 5 percent flexibility will be useful in allowing purchase of large, more mature companies that did not earn a dividend. So when you have a very restrictive dividend policy in the constitution, this 5 percent item in SCA 21 would allow us to also invest in some mature companies that haven't met these fairly rigid dividend requirements.

CHAIRMAN TUCKER: Mr. Blechinger, if the state were to remove all restrictions relative to PERS fund investment, what sort of a return do you think you could realize?

MR. BLECHINGER: My personal feeling is with our board, the way it's constituted, we would not realize much more than we are doing now because the board itself is very conscious of their fiduciary responsibilities and are fairly conservative in their investments. I would say this current board would probably improve on our current investment, but I wouldn't say it's that startling, Mr. Tucker. That's my assessment.

CHAIRMAN TUCKER: But you did mention several times the restrictions that you have now.

MR. BLECHINGER: Right. Oh, I see. You want me to try to quantify what we would expect from that.

CHAIRMAN TUCKER: If all restrictions were removed, what could we appreciate from --

MR. BLECHINGER: I probably should ask my long range planning expert on that.

CHAIRMAN RUSSELL: Would you identify yourself, please?

MR. WILLIAMS: My name is Walton Williams. I'm a Principal Investment Officer for the Public Employees and the State Teachers' Retirement Fund.

It's hard to quantify returns without talking about inflation. Long term studies of markets have shown that stocks and bonds have provided a certain kind of return over inflation with a lot of variability in the period. Simply stated, if we knew what the inflation rate is and you knew what the portfolio construction mix is, you have a better chance of predicting a return. You could improve returns by buying stock. Stocks have provided in the long run historically something like 6 percent over the rate of inflation. Bonds have provided about three. These were referred to earlier, the Ibbotson-Sinquefield. Treasury bills have provided the rate of inflation. But it's very true if you eliminate some of the restrictions, you can have higher inflation adjusted returns. Part of the case for common stocks is based on the larger return it will provide with assuming greater risk over a longer run.

CHAIRMAN TUCKER: The portfolio that you're responsible for is approximately how much you're talking about?

MR. WILLIAMS: It's about $15 billion in the case of the Public Employees' and the State Teachers is another --

CHAIRMAN TUCKER: And you have the privilege of determining where some of this money will be invested?

MR. WILLIAMS: Yes.

CHAIRMAN TUCKER: As a fiduciary for that PERS system, is there any law that requires that you report all of your financial, your private financial dealings?

MR. WILLIAMS: We do provide those, yes.

CHAIRMAN TUCKER: And this is published annually?

MR. BLECHINGER: It goes to the Fair Economic Practices Commission.

CHAIRMAN TUCKER: Is this a public document that anyone is privileged to see?

MR. BLECHINGER: Yes, it is.

CHAIRMAN TUCKER: Thank you.

ASSEMBLYMAN ELDER: Mr. Chairman.

CHAIRMAN RUSSELL: Mr. Elder.

ASSEMBLYMAN ELDER: Mr. Blechinger, are you prohibited from investing in Treasury Bills?

MR. BLECHINGER: No.

ASSEMBLYMAN ELDER: Does the fund currently keep pace with inflation? Is the rate of return up to the inflation level?

MR. WILLIAMS: The rate on the whole fund or the rate on new investments?

ASSEMBLYMAN ELDER: The rate on the whole fund.

MR. WILLIAMS: The rate on the whole fund is somewhat less than the rate of inflation has recently been. Rapidly rising inflation over a period of years makes the average return of funds lower than the current inflation rate.

ASSEMBLYMAN ELDER: You say that Treasury Bills provide you the inflation rate?

MR. WILLIAMS: I said historically Treasury Bills have over the long run about matched inflation rates as measured by the CPI.

ASSEMBLYMAN ELDER: Why don't you just buy Treasury Bills? At least they kept up with the inflation rate. We wouldn't be losing any ground.

MR. WILLIAMS: Because in part historically bonds have provided something like 3 percent over that inflation rate and stocks have provided 6 percent over the inflation rate.

ASSEMBLYMAN ELDER: We had contrary testimony this morning on that very point that it was substantially below the inflation rate and we went back 28 years.

MR. WILLIAMS: If I can make a comment on that, the period that they referred to this morning was part of the data that's the period from 1952 to 1980. 1952 to 1980 roughly corresponds with the great bear market in bonds and the rising inflation, the rapid rise in inflation in this country. If you take that selected period out of the longer study which goes 1926 to 1980, you get a period in which bonds are going to look very bad because the reason that bonds go down in price is that interest rates rise as inflation rises. That has been a long period of rising inflation. If you get the longer period, it wasn't always rising inflation. So you get averages which show you perhaps a larger secular trend.

ASSEMBLYMAN ELDER: And you're telling us that you have an active portfolio management when you tell us that 29 years is, we just got to be patient, that 29 years is not long enough?

MR. WILLIAMS: No, I'm not trying to tell you that. I'm trying to quote the historical record in this context.

At the moment inflation has probably declined from something last year in the neighborhood of 12, 13 percent to where it's 10 percent and most economists, although there's a lot of disagreement, say it's been drifting down. At the moment, as a matter of fact, bonds at about 16 percent provide historically unprecedented real returns virtually.

ASSEMBLYMAN ELDER: This is new market or going into the market and buying --

MR. WILLIAMS: I'm talking about if you go into the market and buy today --

ASSEMBLYMAN ELDER: On discount?

MR. WILLIAMS: On discount or on current coupon even.

ASSEMBLYMAN ELDER: Current coupon could be called if the rate drops down.

MR. BLECHINGER: Well, that was the thing that upset us this morning when he was talking about calls in two or three years. We're much more sophisticated investors than that, Mr. Elder. That's part of the thing we trade in is call protection and everything else. We issue listings of all our bonds with the call protection and everything like that. So when you're talking about calls in two or three years, I can't remember any that we have had called in two or three years.

MR. WILLIAMS: As far as the bond market is concerned, I agree with your premise. We have been heavy buyers of discount bonds for just this reason because we think these rates are very attractive in bonds, don't want to lose them through call in a short period of time. The other class of bonds that's not callable is even current coupon government issues. Most government bonds are call protected to nearly their maturity.

ASSEMBLYMAN ELDER: If you go back in the last three months and put everything you could have into bonds with the way the interest rates are going right now, you'd look like a bunch of geniuses. We probably would be saying that's the way we should be going.

MR. WILLIAMS: Well, the long record for bonds is a little dismal because we have gone through a highly inflationary period through a good part of the '70's. In the early part of '70 stocks didn't do so well. In the latter half of the '70's stocks have done better, bonds have performed badly.

We may be at something of a turning point again. I suspect we are. We have been heavy investors in bonds, but the short run performance of buying heavy in lots of bonds is not very good as long as interest rates are rising and interest rates will rise as long as inflation rises. Now that we have some decline in inflation, we have weak economy, we've got an enormous rally occurring in the bond market. One particular bond which is often quoted by economists are long-term treasury, thirteen-and-seven-eighths of I think 2011 has risen in the last three weeks from a dollar price of $91 to I think yesterday it was $107. It has, in addition to the interest it provides, produced a profit of 16 points on a base of 91 which is about 18 percent in the last three weeks. So maybe we've got the rally in bonds at this point. That still doesn't negate the case though over the long run stocks have an opportunity at a higher volatility and somewhat higher risk in our viewof providing a larger income.

CHAIRMAN TUCKER: With that in mind, what standards have you established for judging the success of PERS investment program? Do you compare like say with Standard and Poor's 500 companies? If so, how do you compare with them?

MR. BLECHINGER: We have an A. G. Becker survey every year, a copy of which goes to the Legislature. It used to be filed with the Joint Legislative Retirement Committee. Quite frankly by law we were required to do that. I don't know where it goes. But I think each of you should have, your staff should have, a copy of the A. G. Becker study on the PERS system.

CHAIRMAN TUCKER: How has PERS compared?

MR. WILLIAMS: PERS has done a little bit less well than the average Becker company. I don't have all the numbers in front of me. It should also be understood that when you're talking about something like a Becker sample you're talking about a sample which has an average fund size of $60 million and we're talking $60 million investment. I believe those are Becker numbers, and correct me if they're wrong. You're trying to compare those with funds of $3 billion approximately in common stocks and there are differences in what happens to such largely different funds. Also, part of our premise here is that some of the restrictions we have in stocks, we've already commented that smaller companies stocks have in general outperformed larger company stocks in recent years.

CHAIRMAN TUCKER: Bank of America could not really be considered as a small company, could it?

MR. WILLIAMS: No.

CHAIRMAN TUCKER: I think PERS is the second largest stockholder in Bank of America; is that correct?

MR. WILLIAMS: That's correct.

MR. BLECHINGER: I assume that's correct.

MR. WILLIAMS: My point was only that the constitutional restrictions that are currently in which require large minimum capital tests, require long dividend record tests, inhibit performance in stocks. They limit you to basically larger companies. Of the S and P 500 which has been commented on here a number of times, a good share of those companies are not eligible for PERS investment because of the kind of dividend and capital restrictions that we have.

CHAIRMAN TUCKER: Were one of those restrictions that maybe we should divest of our investments in South Africa?

MR. WILLIAMS: No, that's not one of --

CHAIRMAN TUCKER: Has any of those --

MR. BLECHINGER: There was legislation, if you recall, Mr. Tucker, but the Legislature has not passed it to date.

CHAIRMAN TUCKER: Has PERS given any consideration to divesting in South Africa?

MR. BLECHINGER: Not to divesting as such, Mr. Tucker.

CHAIRMAN TUCKER: Or to not continue to invest in companies that we know do business with South Africa?

MR. BLECHINGER: No. We have taken an active interest in the proxy votes and we rely on the Sullivan Principle in taking a look at the activities of companies in South Africa. The board, however, looks at each individual case. For example, one company that was in our portfolio had a -- and you can correct me if I'm wrong on this, Walt -- had a vote at their annual meeting on supplying identification cards of photographic equipment to the African Army. We voted against that. South African Army, I should say.

CHAIRMAN TUCKER: Did you vote to --

MR. BLECHINGER: So we do take a look at all proposals at the board of directors meeting and we do have a written policy, but not as extensive as the teachers system.

CHAIRMAN TUCKER: But you voted against admonishing those companies that we do business --

MR. BLECHINGER: We voted in favor of --

CHAIRMAN TUCKER: As continued support of the South African regime.

MR. BLECHINGER: No. Against the South African regime. Again, we filed reports on all our proxy votes.

CHAIRMAN TUCKER: It's a little off the subject but it was a concern of mine.

MR. BLECHINGER: May I continue?

CHAIRMAN RUSSELL: Yes.

MR. BLECHINGER: I'm on page 4, and we briefly had talked about the venture capital portion of SCA 21 and we feel this is really in support in concept. Although some forces or people may exist which would have us place these monies on the basis that we received social benefit, we should not avoid the opportunity because of such fears. A small limit is within assumable risk. We've noted the Ohio fund, the University of California funds as typical of investing in venture pools with favorable results.

CHAIRMAN RUSSELL: Where are you reading, Carl?

MR. BLECHINGER: Page 4.

CHAIRMAN RUSSELL: Thank you.

MR. BLECHINGER: We've also noted at the bottom of page 4 that SCA 21 contains an ERISA-type prudency expert rule. I'll comment later on Mr. Stirling's bill that has a so-called "prudent man" rule. Now, generally what the courts have said, a "prudent man" rule means that you look at individual investments. It's not that clear in the court suits that have taken place, but generally the trend is to look at individual investments and apply a "prudent man" test to that. A "prudent expert" rule in ERISA as it is being interpreted by the federal government, as we read it, take a look at the entire portfolio. In other words, a more diversified look at more of the portfolio and is taking all these things into consideration is this what a prudent expert would do. So we feel the revision in SCA 21 that provides this and spells it out would be advisable for us, too.

CHAIRMAN RUSSELL: On that point, since the numbers of the PERS board, I think most of them are not to be considered experts, investment experts. How would this "prudent expert" rule apply to them in your opinion?

MR. BLECHINGER: The board itself would nevertheless be considered to be prudent experts. When I say "expert," I don't mean somebody like Walt here or somebody with pretty good knowledge. Just about every one of our board members gets that much into our investment program, particularly in the last few years when it has been a subject of so much discussion and interest. So that the members of the board themselves get into the investment program and all the material that go to the investment committee they want. Now, they rely very substantially on the Investment Committee.

CHAIRMAN RUSSELL: Well, in a court case, for example, would they be held up, in other words, if I was going to sue the board for dereliction of duty and so forth and I would say: well, under the "prudent expert" rule we have experts over here, the XYZ Investment Corporation advisors. They're experts and they never would have done this. How come you did and that's why I'm suing you. Could they be in that kind of a bind even though they are advised by their own experts?

MR. BLECHINGER: They could sue us, but we feel we would be holding our own by saying our own experts or the advice that we get is such that the board acted in a fudiciary capacity in doing what it did.

CHAIRMAN RUSSELL: Maybe you need to explain the difference between the "prudent expert" rule in SCA 21 and the present standard that you now have, and would that difference make it more difficult for a member of the board to do his thing as a board member?

MR. BLECHINGER: I feel we treat our investment policy as though we were under ERISA right now, Senator Russell.

CHAIRMAN RUSSELL: What is your actual rule though?

MR. BLECHINGER: It's the "prudent man" rule essentially.

CHAIRMAN RUSSELL: And that's just the average guy out there using his best judgment?

MR. BLECHINGER: It's a little bit more than that.

MR. WILLIAMS: Essentially a "prudent man" rule says that you will make an investment, without putting the proper legal language on, that you will make an investment --

CHAIRMAN RUSSELL: I can't hear you.

MR. WILLIAMS: Essentially the current "prudent man" will suggest that in making an investment one should do that which a prudent man would do in the operation of his own affairs. That's not quite effectively legally the way, but that's the sense of it. The "prudent expert" rule in effect says that you should make investments which a man of similar knowledge acting in a like capacity, in effect, another fund manager would do in the management of affairs. It is a higher standard of test. In that sense I don't believe the board has any problem. You're talking about whether or not the staff or the advisor or whoever is a "prudent expert," and he is a "prudent expert" if he is a man operating in the same capacity as other professional managers as opposed to the man on the street, if you will.

Now, there's another important ramification in there in that in the old "prudent man" rule, the non-ERISA, the old "prudent man" rule, almost any security the judge of prudency, although the case law is difficult, is on an individual security basis. Where it says this security is not prudent. The ERISA-type rule talks about prudency in terms more of total portfolio construction. There may be securities in there of high risk, but that is a collective pool. The risk is properly diversified away.

CHAIRMAN RUSSELL: So you could have one clinker in there, but based upon the overall performance, it would be okay?

MR. WILLIAMS: Essentially that is correct. An awful lot of what we're talking about in venture capital propositions probably couldn't meet an individual test of prudency. They are high risk investments after all and you're talking about whether they're properly diversified. They would probably need a "prudent expert" rule given a proper diversification of higher risk investment. Individually they might not make it.

CHAIRMAN RUSSELL: We have a question from staff.

MR. BALD: Thank you, Mr. Chairman. Carl, can I ask you if you think in the "prudent expert" rule that the ERISA language in the bill in order to do the kind of venture capital investing that's been discussed here today?

MR. BLECHINGER: Not in the constitutional amendment as such.

MR. BALD: But would you want legislative authorization?

MR. BLECHINGER: Well, I'm trying to present what I think is my board's position is this: ERISA is a fact. ERISA is in the law. The times of investing are changing and people are looking at public pension plans. So it's quite appropriate at this time to have the "prudent expert" spelled out either by the Legislature or the constitution. I don't know if I went all around the block on that. What I'm trying to say is, the board is not saying, gee, give us more restrictions or make us more prudent. What this is saying is that given the times and the conditions of the markets and everything else, we believe it's time for a "prudent expert" rule in the law.

ASSEMBLYMAN ELDER: Mr. Chairman.

CHAIRMAN RUSSELL: Yes, Mr. Elder.

ASSEMBLYMAN ELDER: Carl, refresh my memory. Did PERS oppose AB 1347, my home loan bill?

MR. BLECHINGER: Originally, yes.

ASSEMBLYMAN ELDER: Can you tell me why you think it is no one has applied for our loan, no one's been granted a loan?

MR. BLECHINGER: Well, we almost got one. We had a member from your home district and we almost all ran out to kiss him on both cheeks because we were so happy that we had somebody from Long Beach that was going to get it. We had committed to grant the loan to him. As I understand it when the individual found out what the rates were that we were going to have to charge, then they backed out.

ASSEMBLYMAN ELDER: Do you anticipate with the dampening of rates perhaps there will be some?

MR. BLECHINGER: We certainly hope so because it would be ridiculous to have a law with such good intentions on the books and not do anything about it.

ASSEMBLYMAN ELDER: I find it kind of interesting that here we are -- I'm not convinced that the stock market represent a premier investment opportunity. You're asking for broader authority to increase the mix in a fund for stocks. What I was talking about is the home loan program for PERS members, and you opposed that. Now you're in the position as advocating just basically doubling the percentage of the portfolio in stocks. I find that kind of a contradictory position.

MR. BLECHINGER: I'm not going to argue with you because I know where you're coming from and you have your point of view on stocks and the board has a different one on stocks, Mr. Elder.

MR. WILLIAMS: In times of high inflation, stocks are liable to perform better than bonds. In times of very low inflation or deflation, bonds are likely to perform better than stocks. That's a generalization.

ASSEMBLYMAN ELDER: So basically you have bonds and you have stocks, and that's just about the extent of what you can do in current law?

MR. BLECHINGER: We have about three-and-a-half to $4 billion in mortgages and real estate related investments.

MR. WILLIAMS: I'm putting mortgages and real estate investments into the rough bond category, fixed income securities perform --

ASSEMBLYMAN ELDER: You are?

MR. WILLIAMS: I tend to do that. Perhaps I shouldn't.

ASSEMBLYMAN ELDER: I don't think you should.

Bonds and real estate I think are like one is land and, never mind.

MR. WILLIAMS: You're talking about equities --

MR. BLECHINGER: They're getting closer together now though.

CHAIRMAN RUSSELL: Mr. Tucker.

CHAIRMAN TUCKER: What was the interest rate you quoted that prospective customer?

MR. BLECHINGER: I'm sorry, what?

CHAIRMAN TUCKER: What was the interest rate that you quoted?

MR. BLECHINGER: I forget. We do it every month. We take a look at the market. It was probably about 15, 16 percent, Mr. Tucker.

CHAIRMAN TUCKER: And that is the reason I submit to you that you had no takers.

MR. BLECHINGER: That's correct.

CHAIRMAN TUCKER: Because in the private money market you can get 15 and in a lot of instances thirteen-and-a-half percent money for mortgages. So you're going really above the going rate. That was not the intent of Mr. Elder's bill.

ASSEMBLYMAN ELDER: We were trying to create an incentive, Mr. Tucker. They want people to take these loans out.

CHAIRMAN TUCKER: But not at 16 percent. Nor even 15 percent is not a bargain. If you're going to attempt to help people, hey, 15 percent isn't where it is. As I said in one of our other Committee hearings, you buy a home for $100,000 and that's considered low cost housing today, with a 20 percent down payment, amortize your loan for 30 years and your note will be over $1,000 per month, not counting your taxes. That's not affordable housing. That's unrealistic to assume that somebody's going to come in and bargain for your money. You will never get anybody unless he's a real damn fool to come in and pay 16 percent when he can go someplace else and get 15.

ASSEMBLYMAN ELDER: He was from Long Beach, so maybe he's one of my constituents. Be careful.

CHAIRMAN TUCKER: But he's a good person. He was smart enough to back down before he really got hooked.

ASSEMBLYMAN ELDER: The bureaucrats, they get even, you know.

MR. BLECHINGER: Well, I don't feel that, Mr. Elder.

ASSEMBLYMAN ELDER: I do.

MR. BLECHINGER: Certainly the staff has not looked at any way to backstab your bill at all and we had public hearings on the regulations. Many people opposed what the board did, but the board went ahead after the public meeting and voted. So I sincerely hope you don't feel we're trying to backstab you or your bill because it was a well intentioned bill and if the rates go down, we may be able to make some loans.

CHAIRMAN RUSSELL: In that regard, would not the board, could they not be opened to a challenge to their fiduciary responsibility as a prudent man if they granted a benefit such as we're talking about at less than market rate, say, 3 or 4 percent lower as that is not prudent?

MR. BLECHINGER: The board definitely felt that way.

CHAIRMAN RUSSELL: So they would have a liability there?

MR. BLECHINGER: They were concerned that they did have.

CHAIRMAN TUCKER: I thought the intent of the bill was to be very competitive or even to allow them to get something a little bit cheaper because they did have, those people you intended to finance, did have a vested interest in the PERS retirement system and they were using that money, in fact, they were using a part of their money. I thought that the incentive was to let money go out that way just to those people who had, you know, an interest in PERS. I didn't think that you were going to go out and attempt to be competitive or make more money than the private lending institution. I don't know whether that's unrealistic. But you're offering no incentive whatsoever to anybody ready to come and finance a home with PERS money.

MR. BLECHINGER: I'm not saying the current rate is 15 percent, Mr. Tucker. What I'm saying is that is my impression of what it was. Every month the Investment Committee gets a presentation developed by the staff on what the going rates are. As I recall, it ties into the bank rates.

CHAIRMAN TUCKER: And you in fact are going with the going rates out there, so where's the incentive?

CHAIRMAN RUSSELL: May I remind the Committee, I'll be happy to entertain this discussion as long as anybody wants to, but I think it is off the subject that -- it's tangentially related -- but I think it's off the subject that we're here for. If you want to continue with your line of questioning, I'm certainly not going to object.

CHAIRMAN TUCKER: Well, it was investment money and it was a bill that was carried by a member of the Assembly PERS, Dave Elder.

CHAIRMAN RUSSELL: I'm aware of that.

CHAIRMAN TUCKER: We intended to put some money in that area and I consider that investments.

MR. WILLIAMS: Can I say only that it's set based on the survey of prevailing market rates. So the rates were not higher than the rates ordinarily being quoted out there. They were not lower either. But money was available from the program and money sometimes was not available from other lending institutions.

CHAIRMAN TUCKER: I know it's off the subject and I apologize, Mr. Chairman.

CHAIRMAN RUSSELL: No apology necessary.

CHAIRMAN TUCKER: But I submit to you what the intentions were were to get bureaucrats who had a vested interest in PERS because they're the only ones in our system who could qualify for those types of loans, they're the only ones that could qualify. The average worker could not qualify and this meant absolutely nothing to him. Your bill meant nothing unless you could write in there a top interest rate, usury, put it back in. It's the only way you can do it.

CHAIRMAN RUSSELL: Well, in defense of the board, you can talk about anything you wish to and that goes for any member here, but I might caution members from time to time as to what I think the direction is, but this is a Joint Committee and any member can talk about any subject he wishes to if he thinks it's germane. But I would say in defense of the board or the staff that my particular position on that bill was the position that the board did take. I strongly opposed a less than market rate. So that's just my own personal opinion and I'm sure they had a lot of people hitting them over the head from that side as well as from the other side.

ASSEMBLYMAN ELDER: Mr. Chairman, I might say, and Mr. Tucker, the bill was very difficult to get out under the best of circumstances. We got it off the Senate floor with 21 votes on reconsideration and got out of the Senate P and R Committee on a 3 to 2 vote. This was probably one of the toughest bills ever to get, well, in my history, the toughest bill to ever get out and get signed. But the point is, and I think Senator Russell, you know, when we're looking at something as broad in scope as Senate Constitution Amendment 21 which really alters the percentages of funds relative to various investment mediums, it does kind of lend itself to a free flow of discussion in terms of investment policy and I concur with you that we ought to perhaps be focused more on the language of the bill. It's just that I was curious, as long as I had Carl and this other gentleman here, to find out if there is something that could be done in terms of remedial legislation or possibly something in here in terms of an amendment which would provide the opportunity to make home loans available to state and public employees who belong to PERS.

I might say that PERS is the only one that has it. Thirty-seven Act counties don't have it and STRS doesn't have it and I don't think STRS wants it. But the fact of the matter is that we're really in an experiment and I was just kind of curious because I hadn't heard from anybody and I wanted to be there with my picture taken next to them, but we haven't had any loans.

MR. BLECHINGER: I'm glad we held ourselves back. We were dying to call you up and say get your hair cut and everything else, we were ready, but they backed out.

ASSEMBLYMAN ELDER: You guys give me a haircut every time I see you.

(Laughter.)

CHAIRMAN RUSSELL: This is in the area of investments and if there's any other comments on this subject, I'll be happy to entertain them. I'm not trying to forestall anybody. If not, will you proceed then?

MR. BLECHINGER: I'm on page 5 of the prepared discussion. On this we talk about SB 211 and ACA 57, Mr. Chairman and members.

On SCA 21, it broadens the constitutional and investment authority, and while it does that, it doesn't detail controls which Legislature might want to adopt. This is apparently to be done in SB 211 which sets prudency standards and fudiciary standards. The bill also establishes a State Securities Advisory Committee with veto power over venture capital investments and provides for the Department of Industrial Relations to adopt regulations on prudence. PERS opposes both of these provisions. It appears to be an unnecessary exercise in additional government regulations and an incursion into the board's fudiciary authority. We believe that SCA 21 can stand alone and that most, if not all, of SB 211 is not necessary. So perhaps the Legislature can do as they did with the original constitutional amendment is pass legislation that would be consistant with the proposed constitutional amendment. As an absolute minimum, we feel the Department of Industrial Relations approval should be deleted from SB 211. The Director is a good friend of mine, but I can't see any purpose in having a Director of Industrial Relations having veto authority over our particular investments and particularly issuing regulations in that respect.

On ACA 57, -- and I wasn't stallingtill you got back, Mr. Stirling. They were asking questions.

CHAIRMAN RUSSELL: Before you get to 57, back on the 211, you said most, if not all, of 211 is not necessary. From your perspective, is there not anything in the bill that you feel would be needed and minimally what would that be if you had to have something?

MR. BLECHINGER: I don't think I have here the specific amendments we suggested. I'd be happy to provide them to you if you like. There are, as I generally stated, a restatement of what's in the constitutional amendment which allows the Legislature to do whatever, and the prudent expert standard. I will be happy to furnish that. I'm sure we've got it in-house somewhere.

10 CHAIRMAN RUSSELL: Does 21 include the "prudent expert" language? It does not; does it?

MR. BLECHINGER: We provide fudiciary standards with respect to it. It's on page 4 of the SCA 21.

CHAIRMAN RUSSELL: So that sets that out.

MR. BLECHINGER: Right.

CHAIRMAN RUSSELL: And the rest of this bill then, to put it in simple, bitesize terminology, deals with this Security Advisory Committee, the Industrial Relations Department veto and what else is in this that isn't in the --

MR. BLECHINGER: You have on page 5 7509 is added to the Government Code about may invest money in their retirement funds in residential real estate in this state.

CHAIRMAN RUSSELL: You do not have that authority now?

MR. BLECHINGER: I think we have quite a bit. I don't know why this would be needed.

CHAIRMAN RUSSELL: Can you invest in individual residential pieces of property?

MR. BLECHINGER: We can, but we don't. We go through services.

CHAIRMAN RUSSELL: You can now.

MR. BLECHINGER: Yes.

CHAIRMAN RUSSELL: And you don't?

MR. BLECHINGER: Not technically.

CHAIRMAN RUSSELL: But you invest in pools and so forth?

MR. BLECHINGER: Right.

CHAIRMAN RUSSELL: Well, I gather then this bill gives you no authority or restricts your authority in no way other than you have mentioned and is basically redundant from what you have in existing authority and what 21 gives you of the constitution?

MR. BLECHINGER: No. As I understand the constitutional amendments, it permits the Legislature to authorize, for example, the investment of up to 50 percent.

CHAIRMAN RUSSELL: Right.

MR. BLECHINGER: As I understand SCA 21, this would allow the Legislature to say 40 percent.

CHAIRMAN RUSSELL: I'm talking about 211 as it relates.

MR. BLECHINGER: 211 implements SCA 21, Senator.

CHAIRMAN RUSSELL: That's my understanding. You say 211 is basically not needed.

MR. BLECHINGER: Excuse me, I didn't make it clear then. What I was saying --

CHAIRMAN RUSSELL: You say most, if not all, of SB 211 is not necessary.

MR. BLECHINGER: Because most of it has to do with the regulations, the security advisory and so forth. We're saying in SB 211 it really repeats the authorization that is in SCA 21 and that would take care of it.

CHAIRMAN RUSSELL: What I was actually trying to get at, if you struck the provisions for the Advisory Committee and the veto of Industrial Relations and so forth, is there anything else in here that should be continued in 211? We're here to talk about these bills and we need your help and input.

MR. WILLIAMS: You would have very little left if you struck those things. What we were suggesting is perhaps the Legislature might just decide on what percentage within the limits of SCA 21 and make legislation that way.

CHAIRMAN RUSSELL: I get then from what your position or where you're coming from is that you feel that within the limits of 21 you should be given board powers and authorities and it should not be limited by this type of legislation is what you're saying?

MR. BLECHINGER: That's right. We feel the Legislature should make a determination of what the extent of the authority would grant us, up to 50 percent or if you didn't feel comfortable with that, if the Legislature decided 40 percent.

CHAIRMAN RUSSELL: Or 60 percent or no limits.

MR. BLECHINGER: It couldn't be 60 under the present terms of SCA 21.

CHAIRMAN RUSSELL: I mean if we changed it. This is still going through and will be in Mr. Tucker's committee shortly.

MR. BALD: Mr. Chairman, may I interrupt.

CHAIRMAN RUSSELL: Go ahead.

MR. BALD: Carl, you don't feel you need the "prudent expert" rule language in 211?

MR. BLECHINGER: We recommend it be in 211, although it is provided in the constitutional amendment.

MR. BALD: Thank you.

CHAIRMAN RUSSELL: That's what I was trying to get at. I guess I didn't do it very well.

MR. WILLIAMS: The "prudent expert" rule should be one place or another, either the constitutional or in 211.

CHAIRMAN RUSSELL: It could be in the legislation or in the constitution.

MR. BLECHINGER: I think while we're thinking about in terms of translating, the Legislature on its own could make it more restrictive that what it is in SCA 21.

CHAIRMAN RUSSELL: I guess what I hear you saying is if we draw up the parameters, PERS, STRS hires staff, administrators, expert investment counselors and they have elected boards to do the job for that system. To add anything more to it is either redundant or bureaucratic interference in what you're doing.

MR. BLECHINGER: That's correct. I don't want to leave any impression on you that we would not be hiring our own experts in certain areas and I'll be treating with that in my talk later on. But the fact is the board is responsible for the investments of the fund or the operation of the fund and we feel when you bring in extraneous boards of this type or an extraneous department in terms of what we're doing, that it is not a desirable additional layer of bureaucracy.

CHAIRMAN RUSSELL: Thank you.

Mr. Elder, did you have some questions?

ASSEMBLYMAN ELDER: Yes. I was going to ask about the real estate that you do own. Carl, were you referring to mortgages that you're in pools with?

MR. BLECHINGER: Well, one of the problems I have is it lists such sophisticated real estate mortgage investors that we have a variety of them and I have a list here of a couple of months back that I can go through real quickly if you want.

ASSEMBLYMAN ELDER: I just wanted to know on principle here.

MR. BLECHINGER: On residential this is what we would do and this is what we would do in AB 1347, for example. A credit union or a savings and loan would bring one or more residential mortgages to us and we would buy them from them.

ASSEMBLYMAN ELDER: What I wanted to get to was do you own property outright?

MR. BLECHINGER: Yes. Commercial property.

ASSEMBLYMAN ELDER: Now, is that in a pool or does PERS own the building? I mean, I'm not talking about your headquarters. I'm talking about investments where you have them out for rent.

MR. BLECHINGER: We have mortgages, I should say. We don't own them outright. We have mortgages, commercial projects. In fact, they were $450 million a couple of months ago.

ASSEMBLYMAN ELDER: So you own no property from the standpoint of investment?

MR. BLECHINGER: Maybe the confusion is we do have a real estate equity advisor on board. We're negotiating a contract. We do have several properties this company had recommended to us. But to my knowledge, the board has not purchased that yet.

The reason I'm not up to date as the Investment Committee is meeting today in San Francisco considering these, and I didn't know whether Walt knew what was happening or not.

ASSEMBLYMAN ELDER: So heretofore PERS has not owned buildings that have been put out for rental or for income?

MR. BLECHINGER: We have interest in some of them, but we don't own them. We have mortgage agreements where down the line we'll get a share of the rental or we're guaranteed a certain return. That type of thing.

ASSEMBLYMAN ELDER: It's primarily in the area of financing rather than ownership.

MR. BLECHINGER: Yes.

MR. WILLIAMS: PERS has not long had authority to buy real estate equities and they're in the process of gearing up to do it.

ASSEMBLYMAN ELDER: That's what I was trying to get to was you do have that authority.

CHAIRMAN RUSSELL: Proceed to your ACA 57.

MR. BLECHINGER: In ACA 57, this bill, as you know, would eliminate the current constitutional limits on the percentage of asset which can be invested in common stocks by the Public Employees' Retirement System. It would also eliminate all detailed restrictions on investments in stocks such as assets, dividends, and other current limitations. In effect, it would allow the total discretion in the amount and type of stock investments prescribing only a prudency standard. So in principal, the board would support additional flexibility, but the board has not taken a position on this specific piece of legislation yet. There are some board members who are opposed to additional authority to invest in stocks.

I go on to note in this that although we don't see where we would currently find a 100 percent stock portfolio appropriate, specific constitutional limits do not exist with respect to fixed income investment and perhaps should not exist for stocks. This is a personal feeling.

ASSEMBLYMAN STIRLING: We're not proposing by eliminating these restraints on you that you or your board go hog wild in any direction.

MR. BLECHINGER: We had this discussion earlier, and this is part of what I was indicating.

ASSEMBLYMAN STIRLING: My concern is by articulating removing all constraints, you're communicating to those folks out there whose money you are the trustee of that somehow or another that you and your board and your investors and your advisors are going to go to Las Vegas. I'd emphasize that you still would be bound under the terms of this by the "prudent man" rule or even "prudent expert" rule, whichever is most appropriate, which is a substantial encumbrance on your discretion.

MR. BLECHINGER: This is the point we are making in our discussion of the bill that we think it should be the "prudent expert" rule rather than the "prudent man" rule.

ASSEMBLYMAN STIRLING: I'm perfectly willing to do that, but when you characterize it, I'd appreciate it if you'd characterize for consumption out there the different set of constraints rather than total discretion or removing constraints other than the "prudent expert" rule or something like that.

Thank you, Mr. Chairman.

MR. BALD: Well, let me ask you this question. Are you familiar with the "prudent man" language in SCA 57?

MR. WILLIAMS: Yes.

MR. BALD: Has that language as written which contains the phrase at the end "provided that such investment produces a maximum return on a reasonable risk." Would PERS be able to invest in venture capital systems that have been discussed here today?

MR. BLECHINGER: We probably would have to get an Attorney General's opinion on that.

MR. WILLIAMS: I don't claim expertise in the law other than the old "prudent man" standard was an individual judgment and the "prudent expert" is portfolio.

MR. BALD: Prudent person rule.

MR. BLECHINGER: On AB.

CHAIRMAN TUCKER: I would really be interested in knowing your position on Mr. Stirling's bill.

MR. BLECHINGER: I think I'm going to be very interested in finding out what our board feels, too. I would guess they would prefer something like ACA 21 with a "prudent expert" in it, but I'm guessing.

On AB 3, I've noted also the board has not formally acted on this. So the remarks I'm making are based on staff analysis. We're opposed to AB 3 in its current version.

CHAIRMAN RUSSELL: Mr. Blechinger, before you go further, did the staff have any kind of a position on AB 57?

MR. BLECHINGER: No, we haven't.

CHAIRMAN RUSSELL: You have not made a recommendation. Do you intend to --

MR. BLECHINGER: Yes.

CHAIRMAN RUSSELL: -- at the appropriate time?

MR. BLECHINGER: Yes, we have to. It will probably be at the December meeting.

CHAIRMAN RUSSELL: Thank you.

ASSEMBLYMAN STIRLING: Was it because Preprint 3 was shorter that you have a staff position on it?

CHAIRMAN RUSSELL: It's easier.

MR. BLECHINGER: I never thought of that, but it's quite possible.

ASSEMBLYMAN STIRLING: It seems to me like the issues are pretty straightforward in 57 and that you could easily have a personal opinion, if not a full staff opinion, on it.

MR. WILLIAMS: On page 6 there is a proposed sort of opinion that is basically supporting removing unnecessary restrictions which we believe are usually counter-productive.

ASSEMBLYMAN STIRLING: Okay. I guess my concern is that we don't mince words in this entirely important area. It's basically remove some restrictions. Either you want a 50 percent blockade of your discretion or a 40 percent blockade or you do not. If you want maximum discretion pursuant to the "prudent expert" rule, then 57 or something like it is the way to go. I think you should, of all the times you've had the opportunity in the Legislature -- and if it's not my bill, that's fine. If you want to go to somebody else's that does the same thing, that's great. But of all the times in the watershed of history of the management of this fund, when every piece of evidence points to the fact that the arbitrary constraints, the market irrelevant constraints that you have on you is the cause of your lack of responsiveness or the history, now is the time to say unequivocally on behalf of your beneficiaries, the people you're trustees for, that this is the kind of thing that needs to be done and we would like to see it done. I'm talking about the standards in 57.

CHAIRMAN RUSSELL: Maybe that will come in

December.

ASSEMBLYMAN ELDER: Mr. Chairman, along this line, I think it might be easier, and perhaps I'm not convinced what my own position would be on these bills, but I know one thing perhaps that would ease a lot of people's minds if we haven't gone absolutely crazy in the Legislature, and that is that perhaps some kind of bonding mechanism should be developed with respect to the trustees of the fund. So that the dollars are safe whether the person goes to jail or not. I think it's no particular solace to us that somebody might have to go to jail, but I think we would particularly be concerned about what happened to the money. So that might go a long way in allaying some of the concerns that people have. I would think the trustees might feel better, too, if they knew that they weren't financially liable as well as criminally liable. Maybe this is something that could be explored. You might kick that around.

MR. BLECHINGER: I hope you're including staff in that, too, Mr. Elder.

ASSEMBLYMAN ELDER: I don't know. I don't think you guys --

ASSEMBLYMAN STIRLING: The staff runs the place.

ASSEMBLYMAN ELDER: Whatever. But I think that bonding capability would be something that would certainly contain to some extent this ground swell of opposition that I'm anticipating the minute that word gets out about this scheme.

MR. BLECHINGER: We do have some bonding, but there are members of the board from the private sector who are quite concerned with the potential liability because of the size of the fund and the decisions they make.

ASSEMBLYMAN STIRLING: Your staff is not bonded now?

MR. BLECHINGER: Yes. We have the regular state bond and I don't know whether we go up to $3 million. I haven't checked into it lately.

ASSEMBLYMAN STIRLING: Your staff could make a $3 million mistake before 9:00 o'clock in the morning with the amount of money you've got.

ASSEMBLYMAN ELDER: By the coffee break.

MR. BLECHINGER: My attitude is I know I'm not getting the money. If somebody else is, I'd like to know.

ASSEMBLYMAN STIRLING: Well, on your tentative staff possible position on Preprint 3, --

MR. BLECHINGER: We're a little stronger on this.

ASSEMBLYMAN STIRLING: I imagine you are. The language is not as artfully worded as I would like, and I'm completely open on doing that. The question that you would need to address is do you believe or not believe that a better paid, profit motivated series of investment managers working for your staff, with your staff in the measurement role, reporting to the board in the evaluatory role as opposed to having to actually do the buy-sells, would that not be a more productive, healthier format or do you believe that there is no rule for profit incentive investment portfolio managers?

MR. BLECHINGER: I hope I don't sound like I'm hedging. I believe that there should be a mix. That there are certain portions of the portfolio which I'm not ready to spell out now which should be left with in-house staff management.

ASSEMBLYMAN STIRLING: Why is that? I mean, if it's good for $10, it should be good for $1,000.

MR. BLECHINGER: It's good in this respect. There's no reason to go outside to have somebody else manage that portfolio.

ASSEMBLYMAN STIRLING: Because they're so dead or what? They're just not active or what?

MR. BLECHINGER: No. For example, the equity investment portfolio that we have right now where we have Citi-Corp as the advisors for us. But in-house staff and the Investment Committee sets the criteria and, therefore, we invest based on that.

ASSEMBLYMAN STIRLING: Well, this format would be in place of Citi-Corp and their fixed fee irrespective of how productive their arrangement. In other words, you and your 17 people in your buy-sell investment management section would be in the role of supervising, evaluating and reporting on these portfolio managers. So I'm hardpressed to understand what portfolio would be better to manage in-house with the basic theory of profit oriented portfolio managers as sound.

MR. BLECHINGER: Why don't I let -- I'm not trying to duck this, but I think Walt wrote this part of the discussion which I agree with and it's essentially the difference between what we call --

ASSEMBLYMAN STIRLING: If he wrote the answers, I'll have Mr. Bald do the questioning.

(Laughter.)

MR. BLECHINGER: I approve of this and I believe in what he said here.

ASSEMBLYMAN STIRLING: Okay. I'm sorry. Go ahead. Maybe Mr. Bald believes in what I asked, too.

MR. WILLIAMS: What we're suggesting is that we don't believe it will be productive to divide it, for instance, into five managers and have the managers judged on performance at the end of each year. That tends to create something of a horse race that I don't think you would want any interest in the fund. It tends to have the lowest performing manager take a greater chance in order to bring his performance up, in order to continue to get paid, and in order to do that, he's liable to take a greater risk. This is not a particularly good way in our view to run a longer term pension fund. Now, the fund is already advised to some extent. We're talking about professional portfolio managers when we're talking about people like Citi-Bank and Scudder, Stevens and Clark. I don't know that having five advisors instead of one would add that much. The recent trend in portfolio management have been to bring money back in-house for people who have had outside managers, although obviously we're just talking about trends here, because for large diversified portfolios they have often found that these fees are rather high and that performance of outside managers has been disappointing as well as performance of inside managers.

ASSEMBLYMAN STIRLING: You have a lot of conclusionary, inflamatory adjectives here. The fees may be exorbitant, but the fee can be negotiated. So that one's open. If they're not productive, they should be fired. So to say a lot of them have found exorbitant fees and, therefore, this concept is not good, it's not really fair testimony I don't believe. Obviously if they're not performing they shouldn't be retained. I would not be reticent to say that in some regards we could say that Scudder and Citi-Corp have not performed, but they are still retained.

MR. BLECHINGER: Well, we do not say there should not be managers in the areas. What we're saying is you're dictating, the bill the way it's presently drafted, you're dictating --

ASSEMBLYMAN STIRLING: I understand. The discussion is aptly joined on the issue of whether competitive, profit oriented fund managers should be retained or whether staff who are paid a fixed salary, advised by a corporation in New York or Los Angeles that is paid a fixed fee, really has the motivation to maximize return investment consistant with retaining the capital value.

MR. BLECHINGER: What I'm saying is this is exactly what the Investment Committee is looking at now as I've noted here. They are considering hiring specialty managers in certain areas of our portfolio.

ASSEMBLYMAN STIRLING: Would they be reimbursed based on their effectiveness or just on a flat fee?

MR. BLECHINGER: That could be worked out by the Investment Committee. It could go either way, a combination of them. There are many, many ways, as you well know, to compensate these people. But the board I feel would be opposed to saying we must have these and you must look at them every year and either dump them or retain them based on one year's performance. This is why you have upheaval in states like Arizona, the Arizona state system, complete upheaval because they kept dumping managers when somebody wasn't happy with them and you can go into other states where they have the same problem.

ASSEMBLYMAN STIRLING: Once again I hear a lot of staff jargon and conclusionary, inflamatory language that is bantered around the office. I'm really asking you to be quite precise. Obviously I'm not proposing upheavals. At the same time, I think it's appropriate to evaluate the performance of your fund managers at least once a year. We should be evaluating them every day. So I really appreciate it if you would get a little more precise. Do you believe or do you not believe that an arrangement where 5, 10 or 15, an arrangement whereby professional portfolio managers who are reimbursed based on the effectiveness of their productivity is grounds for retaining them and paying them or do you think that a fixed rate, outside advisors staff evaluators are the right way to go? Your answer is, well, a mix. Well, what is the best?

MR. BLECHINGER: Well, I don't think there's any best. You have to decide what's best for your fund.

ASSEMBLYMAN STIRLING: What's best for the fund is to increase the equity and improve the return on investment. Now, how does a staff that gets a fixed salary, 40 hours a week, who I think are underpaid and manage a portfolio that's about $15 billion now and 17 guys do it. A little less than a billion dollars a person and only six of your people have buy-sell authority. That's more than is humanly possible for these people to manage.

MR. BLECHINGER: That's the point I make at the last part of the presentation, but they work more than 40 hours a week, Mr. Chairman.

ASSEMBLYMAN STIRLING: The issue is joined and I would really appreciate you focus on the issue.

MR. WILLIAMS: Let me add another point and stop me if I'm not. One of the ways of hiring outside managers, we're not opposed to hiring outside managers in general. It's just that there are these days more and more specialty managers. We don't think it's advisable to have several managers and have them just compare their performance. You may have managers who are good at particular things. You will expect different performance from different managers. You will expect different performance from growth stock managers to pension stock managers, things like that. We believe this would be a better way to go about it than just comparing absolute performance between managers as is perhaps implied though maybe not intended under your bills.

ASSEMBLYMAN STIRLING: I apologize to my colleagues.

MR. WILLIAMS: Bond managers, pension managers, specialty managers is what we're making a case for.

ASSEMBLYMAN STIRLING: The issue would be the same. Let's say you have five groups of managers and you gave them a certain amount of assets to be responsible for. There's still the net basic criterion, is the equity improving and is the return on investment improving?

MR. BLECHINGER: Relative to risk.

ASSEMBLYMAN STIRLING: And I only put five down as a number, but each of those five managers would have specialty managers working for them and would be competing in all fields of public finance investment opportunities.

MR. WILLIAMS: Well, then, they would have to hire managers because the tendency is for people to have particular expertise.

ASSEMBLYMAN STIRLING: Right. They might hire more than 17 people. They might have more than six with buy or sell. The question is, do they improve the equity and improve the return on investments?

MR. WILLIAMS: We believe that the return on investment could be improved in some cases like hiring specialty managers. Whether you have to hire managers to get specialty managers to do this, I don't know. The board could directly hire specialty managers.

ASSEMBLYMAN STIRLING: So your staff would supervise these specialty managers directly which puts us back in the same role we are now. You have a series of staff,no matter how honest, no matter how well motivated they are, it simply is not humanly possible for them to anticipate the quality of every single investment in a $15 billion portfolio. That's the choke point. That's what's causing you to be not more responsive than you could be.

MR. WILLIAMS: And sometimes I think it's easier to be a manager of managers than a manager of funds simply because a manager of managers often looks at the performance of his manager and says he's hired, He's not so good. We'll change managers. That has not generally been all that satisfactory a procedure. The really satisfactory procedure is to find out what the investments did buy.

ASSEMBLYMAN STIRLING: Let me just ask one question now. The outside investment advisors you have right now are Scudder or Citi-Corp?

MR. BLECHINGER: Citi-Corp advises on equity investments. I should point out now that we get quite a bit of advice from many, many sources.

ASSEMBLYMAN STIRLING: I'm sure your staff reads the Wall Street Journal and that sort of thing.

The question is, did Citi-Corp or Scudder ever write to the Legislature and recommend repeal of certain constraints on the investment portfolio?

MR. BLECHINGER: No. Their approach has been to advise the Investment Committee and the board from time to time: If you did not have these constraints, you would probably be doing better.

ASSEMBLYMAN STIRLING: Did they recommend that you recommend to the Legislature policy changes in this regard and, if so, on the constraints that you were under?

MR. BLECHINGER: They recommend we try to get the legislation.

ASSEMBLYMAN STIRLING: When was that?

MR. BLECHINGER: Well, I don't know.

ASSEMBLYMAN STIRLING: I'd be interested in knowing that. It may change my attitude about Scudder or Citi-Corp.

MR. BLECHINGER: I would also suggest, Mr. Stirling, you may want to talk to the chairperson of our Investment Committee on this specialty advisors or specialty managers we're going to hire because I think they're headed in the direction we're talking about. Our opposition is that you're mandating us by your bill to hire them, to take a look at them every year and divide the assets of the fund. I think if you look into what we're looking at now, I think you'll be --

ASSEMBLYMAN STIRLING: If there were an option that the board could, you think there'd be a more positive response?

MR. WILLIAMS: Then you need to judge from over a longer cycle than one year. The one year results are interesting, but they need to be judged over a full economic cycle.

ASSEMBLYMAN STIRLING: I agree that those are all good points and I'm open to them.

MR. WILLIAMS: Shall we go ahead, Mr. Chairman?

MR. BLECHINGER: I would suggest that we go to page 11.

CHAIRMAN RUSSELL: Mr. Bald has a question, a brief one.

MR. BALD: Carl, can you tell us what would the salaries savings to the fund be if you had outside managers?

MR. BLECHINGER: Salary savings?

MR. BALD: You wouldn't have staff if you had outside managers. What would that save the fund in annual salaries?

MR. BLECHINGER: I have no idea. I assume the board would still want the staff to --

MR. BALD: Do something else?

MR. BLECHINGER: -- ... and everything else.

MR. BALD: Thank you.

CHAIRMAN RUSSELL: Proceed on your testimony, please.

MR. BLECHINGER: I'm on page 11, Mr. Chairman. We're talking about the staffing, we need support staffing, we need quicker action on our investment classes and salary surveys and so forth. We need more freedom to travel out of state to look at our investments out of state. We need more freedom on our budgetary setups. We have to go through the control agency on our budget and this restricts us, too.

With that, I'll recommend the report to you.

CHAIRMAN RUSSELL: What do you mean that you need more authority to go out of state to look at your investments?

If you've got investments in, say, General Motors, you want to go to Detroit?

MR. BLECHINGER: No. We, for example, if you look at our annual report, the best example I can think of is K Mart where we have probably 23 K Mart stores throughout the country. This calls for a site inspection of the premises to insure that it's a good investment. This is the best example. We have many, many others where we go to look at. We wanted to go to consider investing in the Alaskan pipeline and we were unable to get permission to leave the state to send somebody up there to make sure there was even a pipeline. This type of thing.

ASSEMBLYMAN STIRLING: Should have picked two better examples.

CHAIRMAN TUCKER: K Mart.

MR. BLECHINGER: This is the type of thing. We don't want to go traveling all over the country, but it is difficult under the present setup if you have to get three approvals before you go out of state.

MR. WILLIAMS: Sometimes these days there's not that much opportunity ahead of time. They come up rather quickly and travel is a necessary part of an investment operation and sometimes it takes so long to get approvals that we don't have an opportunity to.

CHAIRMAN RUSSELL: K Mart, for example, would that be an investment that your advisors would think would be a good thing to put money into and then the staff would go check it out?

MR. BLECHINGER: No.

CHAIRMAN RUSSELL: The staff comes up with that idea, is that how it works?

MR. BLECHINGER: You want to recall we have pretty detailed rules on investments.

CHAIRMAN RUSSELL: Can you all hear back there?

MR. BLECHINGER: We have pretty detailed rules, not rules, but investment policies on what we do. So all these K Mart shopping centers, where K Mart is the linchpin of it, but they have to meet those criterias established by the Investment Committee before the staff can take a look at them.

CHAIRMAN RUSSELL: Now, you skipped between page 9 and 10 where you did have some recommendations. Were those unimportant?

MR. BLECHINGER: I have a guilty conscience for taking so much time. I tried to summarize that in what I just said, Senator Russell.

CHAIRMAN RUSSELL: Did you?

MR. BLECHINGER: Budget authority, latitude for the board.

CHAIRMAN RUSSELL: All right. Is that it?

MR. BLECHINGER: That's it.

I know one thing we do have on there. I think it's on page 12. There was a discussion this morning about adding additional members to the Board of Administration. We have suggested that perhaps the Legislature would want to consider setting up an advisory board on investments, something like they have in New York state or they have in the state of Washington where people with specific skills in the area of investments can give the board advice on investments, separate and apart from the board. This may be one thing you may wish to consider.

CHAIRMAN RUSSELL: The question arose this morning as to how you do operate your Investment Committee. I see you have an item here on page 12. Why don't you just very briefly talk about your in-house investment management capabilities and how the Investment Committee of the board is set up and who serves on it.

MR. BLECHINGER: I'm losing my voice so I think I'll turn this over to Walt.

MR. WILLIAMS: The Investment Committee generally has on it the member of the board who is the bank member. There's a requirement that somebody from a bank be there.

CHAIRMAN RUSSELL: Is there one now in PERS? Is that spot filled?

MR. BLECHINGER: Yes.

MR. WILLIAMS: Yes.

CHAIRMAN RUSSELL: When was it filled?

MR. BLECHINGER: In March of 1979.

CHAIRMAN RUSSELL: Okay. It's been some time.

MR. WILLIAMS: It was vacant for awhile.

CHAIRMAN RUSSELL: All right.

MR. WILLIAMS: The insurance company member and then the president of the board serves on the Investment Committee.

CHAIRMAN TUCKER: Those are two that do not have to have Senate confirmation; is that correct?

MR. BLECHINGER: None of our board members have Senate confirmation.

CHAIRMAN TUCKER: None of them?

MR. BLECHINGER: None of them.

MR. WILLIAMS: And then elected and appointed members. The point of all this being we do try and get the expertise on the Investment Committee from those members of the board familiar with investments. Our banking and insurance members generally come from the securities side of those companies. Other than that, we do not have, except through training and particular personal experience, necessarily any other investment expertise.

CHAIRMAN RUSSELL: So you have 17 professionals out of the 24, and the professionals are people who come from investment management positions?

MR. WILLIAMS: The staff is hired and many of them come from other institutions managing money, banks, insurance companies. Some of them come in directly. They may have advanced degrees, particularly in areas of finance or MBA's or things like that or accounting.

CHAIRMAN RUSSELL: And that staff is then advised by Scudder?

MR. WILLIAMS: That staff is advised, in the case of the teachers, by Scudder. In the case of the Public Employees by Citibank on stocks, and gets their economic input. Also gets a great many other coverage by most of the other major firms in the country, economic input, individual security, research analysis, et cetera. They, within the framework of the law and the investment resolutions, make the determination if securities suit the needs of the fund.

CHAIRMAN RUSSELL: Okay. Is that it? Thank you very much. If there's no further questions, we'll have the next witness which would be Mike Thome, STRS.

MR. THOME: Mr. Chairman, members of the Committee, my name is Michael Thome. I'm the Chief Executive Officer of the State Teachers' Retirement System. I thank you for the opportunity to appear before you and to discuss investment of public pension funds in California.

CHAIRMAN TUCKER: Excuse me. Do you still have two vacancies on that board?

MR. THOME: Yes, sir.

CHAIRMAN RUSSELL: That's been how long?

MR. THOME: The insurance representative resigned in March, 1979. The banker resigned in June, 1979.

CHAIRMAN TUCKER: And you opposed my AB 2121?

MR. THOME: No, sir. The board did not adopt any position on AB 2121 and I was specifically instructed to make no comment about it. We did not appear on it at all.

CHAIRMAN TUCKER: Suppose I ask you now, when I do bring the bill back, what do you intend to do?

MR. THOME: I would have no information to give you, sir, since I must obey my employer which is the board and I work from day to day.

CHAIRMAN TUCKER: I'm trying to restructure that board to make it more responsive to the needs of the system.

MR. THOME: Yes, sir.

CHAIRMAN TUCKER: I'd like to have a position from STRS on it, even if you're going to oppose it.

MR. THOME: I'll take that message to them and see if they will adopt the position. But they have taken the position not to adopt a position and instructed me stay away from it.

CHAIRMAN TUCKER: If they're going to stay away from 2121, do they have something else to suggest?

MR. THOME: No, sir, they have made no suggestions.

CHAIRMAN TUCKER: And they're happy with the conditions as they are now then?

MR. THOME: I'm sorry, sir.

CHAIRMAN TUCKER: What they're doing is they're showing that they're happy with the conditions as they're existing now with the vacancies on the board.

MR. THOME: I'm sure that they're not happy with the conditions as they exist now. They constantly talk to people. But so far we've had no appointments. I have no knowledge of what is forthcoming in that area.

CHAIRMAN TUCKER: Okay.

MR. THOME: As you are aware, the Assembly Committee on Finance, Insurance and Commerce has evidenced substantial interest in public pension fund investing also. Mr. Tucker's Committee in connection with the Sub Committee on Investment Practices held hearings in Daly City on November 5 and 6 and I understand another one will be held in San Francisco on December the 11th at which you will be discussing some proposed legislation that will come out of the hearings you are currently holding.

I would like to speak to a number of issues affecting the investment of public pension funds. In my view the investing of government pension funds is no different than the investment of private money except for artificial constraints imposed by government. Where such constraints exist, it is unproper, unfair and very misleading to draw comparisons.

The State Teachers' Retirement Systems supports legislation which would broaden investment authority and remove insofar a possible such constraints. In doing so, we believe certain constitutional and statutory changes are needed. These changes are:

1. Enactment of the prudent --

CHAIRMAN RUSSELL: Mr. Thome, excuse me. I note that you have 11 pages of testimony.

MR. THOME: Yes, sir.

CHAIRMAN RUSSELL: Can you paragraph by paragraph or page by page sort of summarize the points you want to make without having to read each one?

MR. THOME: Yes. And then respond to questions. I think I can.

The first recommendation is to enact the "prudent expert" rule as a constitutional amendment as a basic guideline for investing.

The second is to enact into statute the fudiciary standards that do not differ greatly at all from what is applicable to private industry now under the Employee Retirement Income Security Act of 1974.

The third one is to declare that pension funds are trust funds, and that would require a constitutional amendment.

Removal or substantially increase the common stock investment limitations now in the constitution.

Five, removal or reduction of existing restrictions on investments. These would not be needed and are counter productive. They tie the hands of the investor, result in missed opportunities, make it impossible to compare performances among funds and result in reduced income.

CHAIRMAN TUCKER: With that in mind, don't you think we should also put into law some guidelines governing the selection of investment advisors and brokers?

MR. THOME: I think I cover that just a little further on here. I have a list of recommendations of things that might get you where you want to get and get you there rapidly.

The last item that we think should be done, and that is the removal of the administrative budgets of both STRS and PERS from control agency review. Once you have the "prudent expert" rule and the fiduciary standards in place, it's very tight as to what you can do with administrative money. But I think if you do that you should require detailed reporting in the annual report that comes to you and the Governor at the end of each year's operation. There has been some discussion about a committee of the Legislature that would assist somehow in overviewing investment decisions. We do not see that committee as being necessary at all. Even the board itself is not able to participate in day to day investment decisions. If that committee were to function and be really effective, they would have to be on call almost every day when any particular issue came up that needed to be considered because timing is of the utmost importance as you know in making investment decisions.

We do not think a legislative committee is necessary.

There has been discussion about breaking the funds up and putting them out to private management, and I have about 17 points that need to be cleared before we take that step. Those are all documented there and you can read them.

CHAIRMAN RUSSELL: Excuse me, Mr. Thome. Basically on that point, is it your position at this point that that suggestion is not a viable one?

MR. THOME: At this point, yes, sir, I would suggest that it is not a viable one.

CHAIRMAN RUSSELL: Do you think that there would be some things done that would make it a viable one?

MR. THOME: Yes, sir. On the next page, page 6, I'm going to suggest to you a scenario as I call it about how you might proceed with this whole thing to get you where you want to be as rapidly as possible.

First, I would suggest that you pass SCA 21, but look again at stock limitations. Private pension plans are

40 to 70 percent in stocks. I know Mr. Elder doesn't like stocks very well, but nevertheless that's where they are and the testimony of your financial expert this morning was to the effect that that's where you beat inflation.

Second, amend SB 211 which is the bill which you are having the hearing on today to include the fudiciary type standard. STRS has prepared a draft of such language and we are ready to discuss it with you.

Amend SB 211 to repeal or adjust limitations on investments now in the Government Code, Education Code and Financial Code. We are also working on those amendments to propose them to you.

I think that to help Mr. Blechinger because he is ultimately responsible for the administrative details of the investment staff, that we should order a management review of the investment operations to include the organization of it, the staffing, the systems procedures, duties, salary scales, and an implementation plan for recommendations that would come from such a study.

Most important then that if you're going to order such a study, that you provide for the implementation of the recommendation after you have the report. Require the boards to retain expert advisory services in each of the areas of investment, stocks, bonds, mortgages, et cetera, rather than just provide simply for an equity advisor in each one of the funds. I think that the matter of investments in these various areas now has reached a level of sophistication where it is necessary that we retain that kind of expert advice in each of the segments of investment we're engaged in.

CHAIRMAN RUSSELL: We have a question. Mr. Stirling.

ASSEMBLYMAN STIRLING: Why is it that you continue to have PERS staff do contract out and do your investment work?

MR. THOME: First of all, we do not want to be in the market in competition with PERS for the same security. Price of the security alone is enough there and we both are very large investors. Secondly, we have not seen it possible to build a staff of the expertise of PERS staff at the price the state is willing to pay for salaries. Third, thus far there hasn't been a demonstrated need for us to have a separate investment operation from that of PERS.

ASSEMBLYMAN STIRLING: Why do we need two Executive Directors?

MR. THOME: Two quite different systems operating -- well, I suppose you could fire me. That would be about the only savings involved. So far as the workload and everything else is concerned, the same staff would operate and you would still have one --

ASSEMBLYMAN STIRLING: Sort of service to the retirees in processing the claims and all that sort of thing.

MR. THOME: We operate under the same laws, Mr. Stirling. The only difference between our operations would be the nuances of differences in policy of the investment committees of the two boards.

ASSEMBLYMAN STIRLING: Mr. Chairman, I do not expect the staff, any staff for one minute to bless a proposal that gets rid of them. So I hope everybody keeps that in context --

MR. THOME: That thought hadn't entered my mind.

ASSEMBLYMAN STIRLING: -- the discussion of the outside investment process. In fact, I resent the term "outside investment or lose control." The staff may lose control, but the trustees would retain, in fact, enhance the control. The term "private management" also bothers me because it's public management by the trustees of the board through another means. It just doesn't happen to be a means funded by the taxpayer and operated by state employees.

So I would appreciate just for one second besides the 17 once again inculpatory, inflamatory, conclusionary terms that are used here, what precisely do you believe stops the profit motivated investment format from being better than the bureaucratic regular salary employee from doing those investments?

MR. THOME: By a profit motive, what do you mean?

ASSEMBLYMAN STIRLING: You get a percentage of the improvement of their earnings over the prior year or improvement in the value of the equity.

MR. THOME: How would we set that? Do you have an idea? I don't.

ASSEMBLYMAN STIRLING: Sure. Lots of ways to set it. It was pointed out this morning by the gentleman from the evaluation firm that they have dozens of different ways to do it and they relate a percentage of their payment based on that percentage improvement in their productivity by prior agreed to criteria. Now, if we're smart enough to invest $15 billion which means you got to be pretty good with stocks and bonds and every other kind of financial item, certainly you could figure out a way to negotiate a contract that rewards somebody for a good performance.

MR. THOME: Would you propose, Mr. Stirling, to put the entire portfolio out on that basis?

ASSEMBLYMAN STIRLING: I may or may not. I'm asking the questions here because you have already taken a position avidly against this format. So what I'm trying to do is locate what it is you think that a bureaucratic process is better than a profit motivated process?

MR. THOME: I frankly don't know where you would find enough investment operations with the ability to manage stocks, bonds, mortgages and other forms of investment which are --

ASSEMBLYMAN STIRLING: Might I suggest to you that this town alone is crawling with them.

MR. THOME: Of the size that we would be putting out?

ASSEMBLYMAN STIRLING: Naturally I would talk about, say, breaking it to 15. A million dollars apiece is not a bad portfolio. Breaking it down into some more manageable bite.

MR. THOME: The basic concern is if you put it out in that sum of money, the sum of money up to management is larger than the worth of the company which is managing it and, consequently, the company becomes a captive of the account.

ASSEMBLYMAN STIRLING: You're telling me that $15 billion is not larger than the staff that manages it now?

MR. THOME: No.

ASSEMBLYMAN STIRLING: And they're not captive of the account?

CHAIRMAN RUSSELL: They're employees of the account.

MR. THOME: They're employees of the account.

ASSEMBLYMAN STIRLING: I'm still hearing you beg the question and I'm afraid that I'm not going to be able to stand by. I can understand your differing with me and I would just like to know factually why it is rather than be rejoined with questions of how would you do this, that and the other thing. I would be glad to run this program for you if you would like me to. You're paid already eight times as much as I am and worrying about one subject.

MR. THOME: I wish I were.

ASSEMBLYMAN STIRLING: Four times as much.

MR. THOME: Not even that.

ASSEMBLYMAN STIRLING: The question boils down to when you have six guys that have buy-sell authority and they have responsibility for a $15 billion portfolio, it is not humanly possible for them to manage that portfolio, even though Scudder and Citibank fly in and give them their suede shoe advice. They simply cannot do it all. So the two basic theories is, one, is breaking the portfolio into some smaller piece, 5, 10, 15, 20, first. Secondly, rewarding the manager with some increment of return based on their energy, their output. I'm really wondering what's wrong with that idea.

MR. THOME: What prompted --

ASSEMBLYMAN STIRLING: What's wrong with that idea or those two ideas?

MR. THOME: Well, I've laid out --

ASSEMBLYMAN STIRLING: I've read it and I can't find anything relevant in it.

MR. THOME: I could come up with why it wasn't --

ASSEMBLYMAN STIRLING: Could you articulate just one for the tape recorder and the people listening and the press?

MR. THOME: I'm sorry. I didn't hear the question.

ASSEMBLYMAN STIRLING: That's okay. Could you articulate just one basic element -- surely you've thought about this over a period of years and you're ready to articulate that one ultimate truth that denies everything I'm trying to say and backs up what you're trying to say.

MR. WILLIAMS: There's nothing wrong with outside managers. The experience --

ASSEMBLYMAN STIRLING: Not outside, who work for the trustees of the board.

MR. WILLIAMS: Outside as opposed to --

ASSEMBLYMAN STIRLING: Outside betrays a strong psychological bent on your part.

MR. WILLIAMS: There's nothing wrong with hired managers. The experience has been in recent years that hired managers have not been able to outperform the market either. As a consequence, a great many companies have brought money --

ASSEMBLYMAN STIRLING: Hired managers cannot outperform the market?

MR. THOME: Have not outperformed the --

ASSEMBLYMAN STIRLING: PERS and STRS certainly have not outperformed the market.

MR. WILLIAMS: That's correct. Nor have outside managers. I don't mean to be argumentative.

ASSEMBLYMAN STIRLING: That's okay. You can be argumentative as long as you're factual.

MR. WILLIAMS: They have not done it --

ASSEMBLYMAN STIRLING: Have they done better in relationship to the Standard and Poor's 500 than PERS and STRS have?

MR. THOME: I don't know that that's correct.

ASSEMBLYMAN STIRLING: I don't know that that's an answer.

MR. WILLIAMS: It depends on how you want to measure. Do you want to measure it against small funds, big funds, what kind of funds?

ASSEMBLYMAN STIRLING: I would measure it against the poor employee putting their money into a savings account and getting 5 percent compounded if you want to know what I think.

MR. WILLIAMS: Again, without meaning to be argumentative. There's a lot of numbers tossed around here this morning, some of which are quite true but some of which are out of context. Last year these funds, for instance, -- we're talking about how terrible things are -- last year ending June 30th, 1981, in the case of Public Employees' in bonds something like $2,300,000 was invested in an average yield of almost 13 percent in bonds. The same thing is true in the Teachers'. This is the kind of results that other people are getting. These are higher rates than people are getting. Those are the rates on which new money is invested and I believe there's some tendency to confuse those with the rates on average assets over a period of time. The fund has a very active manager, makes a lot of investments at current market rates. The complaint about mortgages was part of this process. We make a lot of mortgage investments.

ASSEMBLYMAN STIRLING: Since you have stated your position, I think that's fine. The fact is if you compare your performance by any criteria with other state pension funds in this state, that your performance has not been as good as some others. I'm not saying that you're bad. I'm just trying to find if we can make it better. That's all. There's no indictment going on here.

MR. WILLIAMS: All I was suggesting is I don't know that this is the process to do it. I tend to believe specialty managers is --

ASSEMBLYMAN STIRLING: Unfortunately, Mr. Chairman, I have yet to find one factual objection to my proposal.

CHAIRMAN TUCKER: Mr. Chairman.

CHAIRMAN RUSSELL: Mr. Tucker.

CHAIRMAN TUCKER: Let's see now, do you publish a full disclosure of all financial transactions of your board members?

MR. THOME: I'm sorry, sir, I'm having difficulty hearing today because I have a cold and my ears got plugged up.

CHAIRMAN TUCKER: Do you come under the same disclosure law as PERS?

MR. THOME: Yes.

CHAIRMAN TUCKER: All financial transactions of your board members?

MR. THOME: All transactions are --

CHAIRMAN TUCKER: I asked a question before and I don't think I got an answer for it. It was, should we also place in the law guidelines for the selection of investment advisors, brokers, and custodians. Shall we place a law guidelines for selective --

MR. THOME: You certainly have that right if you wish to do so, sir.

CHAIRMAN TUCKER: What is your position on that? That's what I asked you just a little while ago and you told me you would relate to that later and I don't think I ever got an answer.

MR. THOME: No. I didn't get to the later part.

CHAIRMAN TUCKER: Oh, you didn't get to the later part yet.

MR. THOME: Yes, you could put guidelines for the selection of --

CHAIRMAN TUCKER: You think there should be guidelines, okay.

MR. THOME: Sure.

CHAIRMAN RUSSELL: Go ahead.

MR. THOME: I was about to suggest a way we might proceed with this thing and that is, of course, to pass SCA 21 but take another look at the common stocks limitation. Two, amend the ERISA type fiduciary standards into SD 211. Three, amend SD 211 to repeal or adjust the limitations that appear on investments in the Government Code, Education Code and Financial Code. Four, order an outside management review of the investment operation as it exists in-house at the present time. Provide for and spell out what the management review is to accomplish. Provide for the implementation of recommendations coming out of that. Require the boards to retain advisory services in each of the areas of investment. Require the board to retain outside expert advisors to assist in setting investment objectives. Require the boards to tie investment objectives to actuarial requirements. Require the boards to perform forward cash flow forecasting. Remove the budget from the overview of control agencies.

It's my contingent that all of this can be done for less cost than putting the money out to private management for one year.

CHAIRMAN RUSSELL: On point eight, "Require the boards to tie investment objectives to actuarial requirements."

MR. THOME: Yes, sir.

CHAIRMAN RUSSELL: Actuarial requirements are set by the actuary based upon facts, figures as he's seen them. The investment policy is, I presume, to get the best and highest and safest return.

MR. THOME: That's right.

CHAIRMAN RUSSELL: Now, how would one change that investment objective because the actuary says something else? It would seem to me if you're going to increase the return above what maybe you would agree would be prudent, there would be some element of risk you might not want to take even though the actuary says you got to bring out more dollars out of the investment.

MR. THOME: I don't see how you could require the board to tie those two together. I'm missing something. This is a subject of which there is a great deal of discussion and which there has been prior hearings so far this year. If the actuarial requirements to fund the fund are a certain thing then are a certain figure. Then on the investment side of it, one should examine the investments, the mix of the portfolio that will most optimally come as close as possible to producing that income. Conversely, if you are looking at the actuarial interest assumption to be used in the actuarial calculations, you should have an awfully good idea of what your long term interest income is going to be so that you place that interest assumption in the actuarial calculation as high as can be reasonably expected to reduce the cost of the system as much as possible.

CHAIRMAN RUSSELL: Mr. Bald has a question.

MR. BALD: On that point, Mike, let me make sure I understand what you're saying. Are you saying that under your proposal here that the firms be managed to produce a rate of return equal to the actuarial assumption? If you have an eight-and-a-half assumption, are you saying you think the fund should be managed to produce an eight-and-a-half return and only an eight-and-a-half return?

MR. THOME: No, sir. I'm saying that both of these things have to be done in concert, the setting of the actuarial interest assumption and the setting of the investment objective. You want to obtain the greatest return possible with safety of principle on the investment portfolio. You want to adjust your interest rates as close to that as you possibly can and keep adjusting it every time you do an actuarial evaluation so that you stay on target.

MR. BALD: May I pursue that, Mr. Chairman?

CHAIRMAN RUSSELL: Sure.

MR. BALD: There was testimony this morning recommending a floating rate. There was testimony this morning that one of the larger city retirement systems revises its actuarial assumptions annually. How often does STRS revise its actuarial --

MR. THOME: STRS does an actuarial evaluation every two years, an actuarial experience analysis every four years. The statute requires one every three years.

MR. BALD: Thank you.

CHAIRMAN RUSSELL: Proceed.

MR. THOME: There are some other issues that I wanted to just briefly comment about. One is cost of living adjustments for retired persons. The suggestion has been made that these might be paid for from excess interest earnings or from a fund variancy called a contingency reserve. STRS has no such fund in existence. We abolished it some years ago. The setting aside of interest earnings to cover down years of earnings on the investment portfolio or to smooth actuarial interest assumptions was the basic justification for the establishment of those funds where they exist. In practice, as you probably know, they have been viewed as a pool of assets undedicated to any purpose and have been used for benefit improvements. STRS with a $10 billion plus unfunded accrued obligations could scarcely claim to have anything excess. Therefore, cost of living adjustments for STRS retirees must come from increased contributions by employees and employers or from a reduced retirement program.

CHAIRMAN RUSSELL: Is it your position that there is no such thing as excess earnings in a pension fund?

MR. THOME: Yes, sir. There is no such thing unless it is a fully funded pension plan. Only then does something become excess.

CHAIRMAN RUSSELL: Is it your position then that a pension fund, a contingency reserve fund and a pension fund is not a necessary adjunct to the system?

MR. THOME: Yes, sir. That's why we abolished ours.

CHAIRMAN RUSSELL: Thank you.

ASSEMBLYMAN STIRLING: Did Scudder recommend otherwise?

MR. THOME: No, sir. Scudder wasn't around then.

ASSEMBLYMAN STIRLING: Is Scudder your advisor now?

MR. THOME: Yes.

ASSEMBLYMAN STIRLING: Did they recommmend that you have a contingency reserve of approximately 4 percent of assets?

MR. THOME: No, sir. They have not thus far.

ASSEMBLYMAN STIRLING: That's amazing. They recommend to the city of San Diego that they raise theirs from $2 million to $12 million precisely because it's state-of-the-art that they have contingency reserves. Thank you.

MR. THOME: It allows you to hide a lot of things.

ASSEMBLYMAN STIRLING: Including productivity. How in the hell did the State Teachers' Fund get so out of whack in terms of its unfunded liability?

MR. THOME: It came into being in 1913 and when it opened its doors service credit was granted to all teachers then in the force for all service performed prior to that time and no money was put in the fund.

ASSEMBLYMAN STIRLING: It's behind all these years?

MR. THOME: The teacher contribution was $12 a year until 1935 when it was raised to $24 a year. The law altering that time provided that any money not in the fund would be provided by the State General Fund.

CHAIRMAN RUSSELL: Pay as you go.

MR. THOME: Yes. In 1944 the system was overhauled. Some funding was in a bill but it was removed before the Governor signed it. From then on until 1972, July 1, '72, we operated as a pay as you go system. When I came here in 1968 the bill I delivered to the Legislature was $71 million and in 1972 it was $98 million and it was going to be $360 million in 1980. So we began to put the system on a reserve funding basis at that point. That's how we got so far behind.

ASSEMBLYMAN STIRLING: Thank you, Mr. Chairman.

CHAIRMAN RUSSELL: Proceed.

MR. THOME: The second item is one that was referred to at the hearings that I previously spoke to in San Francisco and Daly City, and that is social investments or alternative investments. Issues which should be dealt with. I attach to this paper a copy of our so-called investment responsibility policy and also a copy of our stockholder voting, proxy voting policy and procedure for your perusal and any legislation you may view necessary in those areas.

I'll close with that, sir.

CHAIRMAN RUSSELL: What is the, very briefly, what is the social investment policy of the STRS board?

MR. THOME: Social investment policy, bottom line, is that all -- first of all, the investment must meet the "prudent man" rule. In other words, it must have the highest rate of return with safety of principle. Thereafter, if social issues are a consideration in the investment, a choice will be made between equal investments as to the one that produces the greatest or the least amount of ill or forwards a socially desirable policy.

CHAIRMAN RUSSELL: Is it not inherent in the terminology "social investment" that somewhere there will be either a diminution of return or safety?

MR. THOME: There are many who view that as being the case. That is not necessarily so.

CHAIRMAN RUSSELL: Well, then, if it's not necessarily so, or if it's not so, then it falls into a normal investment.

MR.THOME: Well, many people would say that buy California is a social decision. STRS has always bought California, all other things being equal. We have restricted all our FHA, VA mortgages, our conventional single-family mortgages and so forth, all restricted to California. Of course, GNMA's are pools and you cannot restrict those. But all things being equal, we do buy California first. We do business with all firms in California before we do it anyplace else.

CHAIRMAN RUSSELL: Okay. Any other questions?

Does that conclude your testimony?

MR. THOME: Yes, sir.

CHAIRMAN RUSSELL: Thank you very much.

Next witness will be Dwight Stenbakken, League of California Cities. I understand that, -- is Dwight here?

MR. STENBAKKEN: Mr. Chairman, I'll be glad to defer and submit anything in writing to save you time.

CHAIRMAN RUSSELL: Why don't you just, if you have anything you want to capsulize -- don't read a statement -- but anything that you feel that you'd like to let us know that the League's position or observation on these bills that might be helpful.

MR. STENBAKKEN: Thank you, Mr. Chairman.

CHAIRMAN RUSSELL: We'll take a brief recess while we change tape.

(Thereupon a brief recess was taken.)

CHAIRMAN RUSSELL: All right. We're back on the record again.

MR. STENBAKKEN: Mr. Chairman, members, Dwight Stenbakken with the League of California Cities.

In relationship to the three bills, its obvious the intent is to increase the investment of the PERS portfolio.

CHAIRMAN RUSSELL: Speak into the microphone, please.

MR. STENBAKKEN: To that extent we are supportive of a number of provisions in the bills. We are very concerned with the increased contribution rates that we are experiencing every year to cover the growing obligations of the systems. So of course to any extent that the investment earnings can be increased, we're supportive.

CHAIRMAN RUSSELL: They can't hear back there so you need to talk right into the microphone.

MR. STENBAKKEN: Relating to that I see three quick issues that we'd like to touch on briefly in relationship to the bills. First of all, on the amount of investments which can be placed in the stocks, the League at its recent annual convention took a position in opposition to SCA 21, and that's somewhat of a departure from most of the other people who have testified here today. The rationale behind that was primarily because of the recent performance over the last ten years of stocks. They just simply haven't been good investments based upon some of the reports that we read and that went into that policy statement. Therefore, the rationale behind the policy statement was that we, therefore, should not support increasing the amount of investments that go into stocks. I do think, however, that we are flexible enought and that the general intent of the policy position that we adopted at the conference is if we can be convinced in any other way, shape or form that stock investments are something that will improve the investment return, I think that that's something that we could support.

We had an interesting discussion at the Daly City hearings about exactly how to evaluate, how to measure your returns in stocks, and it can't necessarily be measured simply by the amount of dollars coming in the door. There are other measures that you might want to look at. That was an interesting discussion at that meeting that I think would be interesting to explore in terms of PERS when they report their return. I'm sure that will make them very happy that they're going to add that to their annual report.

The other question which has been raised by our city's relationship to the investments of STRS has been the amount of money going into long-term versus short-term investments. It has been the position of a number of cities who are members of the League that there should be more monies going into the short-term markets. They're looking at their own investments. They're running between 15 and 20 percent on their own funds and are concluding that maybe there is something to be gained by being a little bit more flexible in that area in terms of PERS and its investment in short-term.

We have adopted a position of taking a look at that through some type of an independent study to see if, indeed, maybe PERS ought to rethink the amount of money that they are investing in those areas.

Last is an issue which we have talked about before; and that is the interest crediting rate. If, indeed, the object and purpose of the three bills or four bills in front of you are to increase the interest earnings on investments, then it seems as though we also have to tackle the credit or the problem of the interest crediting rates. It has been our position that PERS has been significantly understating the interest crediting rate in the amounts of monies that have been placed back into the system to defer obligations.

We have an unbending position on that. We think that they should be higher, significantly higher than they are.

Lastly, in terms of ACA 57 and the cost of living adjustment, the issue which Assemblyman Stirling has proposed in various packages, we don't have a position yet and we will in January. It will be a very important concern in this whole retirement question.

CHAIRMAN RUSSELL: Do you have any position on 211 as it specifically relates to this Security Advisory Committee?

MR. STENBAKKEN: No. No, we do not.

CHAIRMAN RUSSELL: Or anything else in 211?

MR. STENBAKKEN: No. We generally support the areas that provide for more flexibility in investing in stocks that they currently cannot invest in and presume --

CHAIRMAN RUSSELL: Well, I presume if you took a opposed position on 21 there would be no reason to get to 211. I guess that would follow.

Thank you, Dwight. Any questions?

Dick Dunn of Scudder, Stevens and Clark.

Is this the Scudder that we've been talking about?

ASSEMBLYMAN STIRLING: Yes, indeed.

CHAIRMAN RUSSELL: Mr. Dunn is not here? All right. If Mr. Dunn is out in the hall and comes in, please let me know.

How about Ralph Capo, Financial Consultant, Coast Mortgage. Please come forward.

MR. CAPO: Mr. Chairman and Committee, thank you for the opportunity to address the board.

For the record my name is Ralph J. Capo, Investment Counsultant with California Coast Mortgage in Santa Anna, California. I would like to introduce the company President, Donald E. Kutch, K-u-t-c-h, who will, in my place, address pension investment and short-term and residential first mortgages.

CHAIRMAN RUSSELL: Please proceed.

MR. KUTCH: My name is Donald Kutch, California Coast Mortgage. Our product is first mortgages. But first of all, I'd like for you to remember one thing, the Golden Rule. The person with the gold makes the rules. There's no point in selling your money for less than what it's worth.

All land with or without improvements is a candidate for a first mortgage. It has a value to somebody. They feel they can pay rent on the money and still make a profit. That's one of the basic reasons for first mortgages. There's a profit motive in it for everybody.

You can have a single family dwelling or you can have the World Trade Center Building, either one of them will give you return on your money. It will keep up with inflation.

The savings and loans have been lending money on single-family dwellings for 150 years. Their losses run less than one-tenth of one percent of their entire portfolio, year after year after year.

If you want a little bit of background, there is a company in Los Angeles that's called Lionel D. Edde Company. They're a subsidiary of Manufacturers Hanover Trust. They have funds that have been invested in real estate loans for a period of 18 years. I think if you contact them, you'll find out that their yield has been far greater than any stocks or bonds of any other investment portfolio.

You can have a first mortgage from as little as $1400 to $70 million that I know of. At Disneyland Hotel, which we just refinanced awhile back, some pension funded on it $70 million. I think they got around sixteen-and-a-quarter percent interest rate.

We can currently place $25 million a month at 18 percent interest. That doesn't mean you're going to get monthly payments of 18 percent interest. You get monthly payments based on 10 percent interest and you'll get an 8 percent addition to your principal at the end of each year. That would be a three year mortgage that would be renegotiable at the end of three years. The demand you can't satisfy.

Right now we know of $25 million a month that could be placed that way, single-family owner occupied.

Do you have any questions?

CHAIRMAN RUSSELL: Are there any questions?

Are you working with any pension funds, private or public?

MR. KUTCH: Yes. We have the Southern California and Arizona Glazers and Glass Workers Pension Profit Sharing Plan. They've been with us now two years. We have probably 400 corporate and individual pension plans from $1500 up to $100,000 in the mortgages.

CHAIRMAN RUSSELL: Mr. Stirling has a question, I believe.

ASSEMBLYMAN STIRLING: Is there something about the present state law or policy that keeps the public pension funds from investing with you?

MR. KUTCH: Not that I know of. They just don't know about us. We just haven't been able to get out and talk to them. This is our first opportunity.

ASSEMBLYMAN STIRLING: Okay. I got it.

CHAIRMAN RUSSELL: Thank you very much.

The next witness will be Mr. Sidney Kaufmann, President of Kaufmann and Goble Associates, actuaries and consultants and a consultant to this Committee.

MR. KAUFMANN: Thank you, Mr. Chairman. My name is Sid Kaufmann. I'll keep my remarks fairly brief. I have only several points to comment on.

Perhaps just to shed some different light on the discussion today. I will submit that SCA 21 and SB 211 might be viewed in a different perspective. Without trying to sound cavalier about it, my approach would be to sit back and ask why not implement something in this direction? In asking myself that question, I tried to develop some legitimate, cogent answers. I think the one that is coming back to me is one that I believe has been implicit in all of the discussion we've had in all the committee meetings that I've been in on; and that is fundamentally does it impair the retirement system? If the concern is that of impairing the retirement system, then I submit there may be alternative ways to constrain the potential for abuse other than setting arithmetic constraints that might at the same time end up impairing the rate of return on the system.

CHAIRMAN RUSSELL: You think it might impair the system?

MR. KAUFMANN: Pardon me?

CHAIRMAN RUSSELL: You think these bills might impair the system?

MR. KAUFMANN: I think one could create a scenario where they would. For example, if we buy the premise that an aritmetical constraint on equity investment is good, and I believe that when it was first imposed that the belief was that it was good. It was good because they would foreclose any possibility of abuse. By removing that constraint, then one has to, unless they changed the philosophy, agree that there is a potential for abuse. I think the potential for abuse is probably more prevalent, if it is prevalent, in smaller systems as opposed to PERS and STRS. My experience in most of the systems is that there would be very little likelihood that there would be an abuse by removing arithmetic constraints. This gets back to my first part of my statement.

What is the harm in removing the arithmetic constraints on the portfolio's investment if, at the same time, we structure the legislation, constitutional amendment enough constraints of different types to essentially foreclose on any abuse in the future which may open the door for greater returns. So I think there's simple possible ways that could happen. One, obviously, is the "prudent expert" rule. Another is stop telling the "prudent expert" rule with very stringent fiduciary responsibility provisions such that, and this may seem onerous at first brush and impossible to implement at second brush, but implementing fiduciary responsibility provisions constant with those in ERISA and holding those individuals who serve as board members or who are deemed to serve in fiduciary positions in respect to retirement systems are personally liable for malfeasance or abuse. Such that, as under ERISA, participant litigation can be introduced in the event of abuses.

Now, the way to constrain -- let me back up. With that kind of scenario I think it's possible also to create a situation where nobody would be willing to serve as a member of such a retirement board. We find that not to be the case in the private sector. Certainly there's no constraint that curtails the participation as a member of the Administrative Committee to on a corporate retirement system or in a Taft-Hartley jointly negotiated retirement system. The reason for that is we're seeking and finding fiduciary liability insurance. So coming full circle, if we were to remove arithmetic constraints, at the same time require for the exercise of portfolio management without arithmetic constraints the establishment of fudiciary liability insurance and holding those members of the board who are in trustee positions responsible under legislation similar to that enacted under ERISA, I think you would arrive at the same condition with the "prudent expert" provision. You have a retirement board that is duty bound to invest at least from the surface in a responsible manner and has a latitude to invest in a wide variety of investments through "prudent expert" provisions. Then the protection to the participants and as protection to participants also protection to the sponsor in terms of potential abuse would be the return through fudiciary liability insurance of any shortcomings as a result of mismanagement.

Now, the one detracting element from this is it may be impossible to secure that kind of fudiciary liability insurance. But I would submit that as soon as we approach it from the backdoor in terms of why not remove the constraints, we could start to get a little more creative in ways to perhaps protect the system, at the same time, create the possibility for higher returns.

I'd be happy to discuss that briefly.

I think in terms of the proposals before you that are fairly detailed, for example, if the involvement of the Department of Industrial Relations and such, there would be counterpart provisions that would parallel those in ERISA and would simply establish prohibitive transactions in respect of dealing with parties in interest for retirement systems. Although the Department of Labor is basically charged in the private sector with overseeing the implementation of prohibitive transaction exemptions and the involvement and the protection of their retirement systems in respect of abuse by party in interest, I think something of a parallel nature could be implemented in California for public systems.

That essentially is the substance of my comments in respect to these proposals. I don't think I can add anything to what's been said today specifically. I'm sure that we can trot out a number of statistics that on the one hand you could support and the other hand rebutt every contingent that was made today. It's not my intent to do that, but simply to try to spur some kind of discussion in terms of alternative approaches.

CHAIRMAN RUSSELL: You have spurred Mr. Bald. He has a question.

MR. BALD: Sid, going back for a moment to your scenario of arithmetic constraints and their price, do I hear you saying that the price of the insurance that the systems are now paying for arithmetic constraints is the reduced rate of return on investments?

MR. KAUFMANN: I think there's a soft dollar cost to it. At least if we can believe the testimony today and the testimony I've heard in other instances, that's very definitely the case. I am sitting as a member of a blue ribbon commission for the City of Los Angeles and reviewing their fire and police retirement systems. They have chosen traditionally to impose a different kind of constraint on their retirement system. Their restraint is specifically arithmetic, but is one such that prior to the approval upon suggestion by the investment manager of an investment in their system, the Board of Pension Commissioners has to meet and give their blessing to the investment. The Board of Pension Commissioners meets on Thursday. That means that any potential investment to be made by the investment advisor must first be cleared on Thursday morning by the Board of Pension Commissioners. Now, I'm sure at the time that was initiated it was well intentioned and the intent I would infer would be one to protect the system against abuse. After all, we have an involved group of citizens, seven members of the Board of Pension Commissioners who have a direct interest in the system through their citizenry in the City of Los Angeles overseeing the professional investment manager. But we all know that in today's investment medium, that the waiting of as long as six to seven days before the placement of investments essentially curtails the rate of yield.

My point is there's good analogy being that and the implementation of an arithmetic constraint. Anything that hamstrings an investment manager, carries with it the possibility of lower returns and that possibility of lower returns can only be weighed against the greater consideration in terms of protection of the members of the system and the ultimate cost of the system. I think what we've heard today as testimony, but the cost of the system, although we haven't heard direct testimony in regard to fiduciary insurance, could be inferred to be greater than the cost of the system for securing the kind of insurance that would protect against any deliberate abuse.

MR. BALD: Thank you.

MR. KAUFMANN: Incidentally, I wanted to make one other comment, too, because I think there's a possibility for misinterpretation. Whereas the testimony was that PERS' staff members are bonded, that is not the same thing as having fudiciary responsibility insurance. The bonding simply protects the system against somebody running away to Brazil with some of the funds. Fudiciary responsibility insurance I'm talking to is somebody who knowingly either breaches his fudiciary responsibility by not acting, if you will, in a manner consistant with a "prudent expert," or somebody who's aware of a breach and doesn't act to prevent further breaches.

CHAIRMAN RUSSELL: Any other questions? Thank you, Sid.

The next people on the list would be Gene Stegelmeyer and Nadine Stegelmeyer, and then Richard Lucero and Aaron Read, and we will wind this up at least hopefully at nine minutes of four. If we don't wind it up at nine minutes of four there will be other Committee members who will stay and take testimony, but I must leave.

CHAIRMAN TUCKER: These are my constituents. So you have to be nice.

CHAIRMAN RUSSELL: I'll be very nice.

MS. STEGELMEYER: I was going to say that, but as long as you did, I won't have to.

I'm Nadine Stegelmeyer. This is Gene Stegelmeyer. We are members of the Association of Retired Teachers, an organization of about 1200 very active retired teachers.

CHAIRMAN RUSSELL: Boy, I'll say they are.

MS. STEGELMEYER: There are several reasons why our organization has strong reservations about these bills and constitutional amendments. In the first place, they appear to be a not very subtle first step by certain interest groups to gain access to our funds for their own profit or social goals.

The bills follow shortly the interim report of the Governor's Public Investment Task Force. We were not privy to the final report as Mr. Stockel was. This report recommends a variety of programs involving the use of our fund for what the Task Force perceives as were the social goals. Such use will be possible only through the passage of these bills and others we fear will follow to remove investment restrictions and perhaps even to require the fund to be used in pursuit of these goals.

CHAIRMAN RUSSELL: Miss Stegelmeyer, because we do have a time constraint and I'd like to hear the testimony, if it's at all possible -- of everybody -- could you, without being detrimental to your testimony, could you sort of summarize the paragraphs or pages in your own words as to what you're trying to say rather than to read them? Would that be possible?

MR. STEGELMEYER: We sat here all day and heard other people take an hour. The very people whose money is being discussed are not allowed ten minutes. It takes us ten minutes to read this.

CHAIRMAN RUSSELL: You have a good point and I cannot refute it. I just asked you if you could. Obviously you cannot.

MS. STEGELMEYER: Perhaps an even more crass and open campaign for tapping our fund is that waged by the real estate and construction industries.

We retired teachers, as these remarks thus far indicate, sincerely believe that these efforts to gain access to our fund represent a potential threat to our financial security. We are and have been waging what appears to be a futile campaign to get some relief for and protection from the inflationary erosion of our pension purchasing power. Now we have to face a second front in resisting the kind of thinking these bills represent.

This kind of thinking is exemplified in the report of the Governor's Interim Task Force on Investment Policy which incorporates philosophical principles which we challenge, and we can talk to those if we are questioned.

Apart from what we consider to be an inappropriate philosophical basis for this type of legislation, we have a coldly practical concern. Our fund, we are constantly told by the same legislators who are considering opening it to other groups and purposes, is in deep trouble. It has a tremendous unfunded liability. It is unable to finance cost-of-living adjustments or even to assure that the value of our pensions will not eventually be eroded to nothingness. Yet this legislation proposes no benefits for us in exchange for the use of our fund to benefit others.

Few, if any, groups have lost as much as retired teachers as a result of economic conditions in recent years. Yet this legislation proposes use of our fund to help the ailing real estate and construction industries, industries that have been almost obscenely profitable until very recently. These industries have not only profited from the inflation that has been so damaging to retired teachers; they have actually encouraged and fostered it. It would be masochism for us, through our fund's financing, to enable builders to return to their concentration of ever larger, more luxurious, energy inefficient dwellings. This would be analogous to financing a Chrysler Imperial assemblyline.

It would be stupid for us to make funds available for financing new rounds of exhorbitant wage and benefit demands by the building trades while we have to settle for less than 2 percent a year. If our fund can help to restore the health of these industries, why does the legislation not provide for some share of the profits to be paid into the fund for our benefit? Assembly Constitutional Amendment 57 is meaningless in this respect, since the magnitude of our unfunded liability makes it highly unlikely that earnings will ever exceed the amount needed for actuarial soundness.

Not only does the legislation propose no benefits for our fund; it actually jeopardizes its already fragile health. Investment in the kinds of securities these bills would open to the fund have been proscribed in the past because of their admittedly riskier nature. Yet, the bills do not even provide for the state funded insurance protection the Task Force recommended. What is worse, the bills insultingly and arrogantly omit any requirement that active and retired teachers be included in the membership of the State Securities Advisory Committee. As for residential mortgages, 25 percent of our fund's portfolio in 1980 was invested in real estate mortgage loan investments, 38 percent in California properties. SB 211 would remove all restrictions on residential mortgage investment in spite of the fact that such investments have been largely ignored by pension funds for numerous reasons, and we can enumerate those if we're asked to.

And the new, creative financing approaches are not any more inviting. Variable rate mortgages have been generally unacceptable to the market, and shared appreciation has as its converse, shared depreciation.

We do not take the position that investment policies are set in concrete. We do take the position that any changes in these policies must inure to our benefit. We cannot accept any change that increases risk for our fund unless there is a firm guarantee against loss. We cannot accept any changes which do not give active and retired teachers a voice in those changes. We cannot accept any change that is not directed toward the defeat of our worst enemy--inflation. We cannot accept any change that will benefit any other segments of the economy unless we are assured of a share of those benefits.

This may seem to be a hard-nosed position, but we are hurting. We were low men and women on the totem pole during all our working years; we do not intend to be exploited during our golden years.

(Applause.)

CHAIRMAN RUSSELL: I'm sure this elicits great joy on your part in the audience, but please if you would not demonstrate for or against any statements. We would appreciate it.

Are you aware of my bills, SD 45 which deals with the funding of STRS and the latest version?

MS. STEGELMEYER: Not the latest version. We haven't seen it since spring, I think.

CHAIRMAN RUSSELL: That I think is the latest version. It had in it a provision which would provide an ad hoc benefit for retired teachers, putting them up to 60 percent. Are you aware of that provision, 60 percent of their original purchasing power?

MR. STEGELMEYER: I wasn't aware this was in your bill. This, of course, was addressed to 629 which we worked on a few years ago.

CHAIRMAN RUSSELL: Same concept. I didn't know whether you knew we had put that in the bill.

MR. STEGELMEYER: No. I'm encouraged to hear that.

CHAIRMAN RUSSELL: Well, don't be, because the bill's in trouble.

MS. STEGELMEYER: I was going to ask what's the status of the bill now.

CHAIRMAN RUSSELL: Well, unless we get some agreement with the teachers, it will not fly in its present form. The only way we are able to do that is by making some savings in the existing program, changing the retirement age, changing the disability factors, taking those savings and providing some additional benefits for retirees. But if we can't do that, I want you to be aware of it anyway.

MS. STEGELMEYER: We can't speak to that point now because we're speaking as organization members, but personally we would have a point of view on that.

CHAIRMAN RUSSELL: I just wanted to know if you were aware of it.

Any other questions?

ASSEMBLYMAN STIRLING: Yes.

CHAIRMAN RUSSELL: Go ahead.

ASSEMBLYMAN STIRLING: Mr. Stegelmeyer, I now understand why you were so peremptory with me this morning in the coffee shop. In reading the page 4 and listening to you talk about ACA 57, it's meaningless. I've been called a lot of things in my life, but not meaningless along with my bills.

I don't think you understand what it does. I really wish you had asked me about it instead of written this or asked me about it when you had a chance. What it does is provide precisely what you're asking for which is the difference between the actuarial assumption that is adopted by the actuary or adopted by the board. The difference between that and the actual earnings on interest are split between benefits for existing retirees and retiring of unfunded liability as it is in the City of San Diego plan, but it's not working for another reason. So I guess I'm sorry that you have so many friends here who have heard you now write and say that ACA 57 is meaningless when I went out of my way and have taken a great deal of grief over attempting to do anything for retirees. So when you get a chance, I hope you will reconsider your position and examine it a little further and I promise not to move forward with ACA 57 until all retirees are in agreement that it's the right thing to do.

MS. STEGELMEYER: Thank you.

ASSEMBLYMAN STIRLING: In the meantime, I think you're just going to end up on the short end of the stick.

MS. STEGELMEYER: Well, we've been on the short end of the stick.

ASSEMBLYMAN STIRLING: One of the reasons you'll stay on the short end of the stick is by being against things rather than for things. I had proffered a solution which you didn't take the time to understand or even ask me about when I was in the same room with you, and this is the kind of indictment I get. Maybe others have had that unpleasant approach to it.

MR. STEGELMEYER: May I respond to that?

ASSEMBLYMAN STIRLING: Did you write this?

MR. STEGELMEYER: Yes.

ASSEMBLYMAN STIRLING: I'm sorry, Mrs. Stegelmeyer. Yes, sir.

MR. STEGELMEYER: We wrote it in conjunction.

MS. STEGELMEYER: And it has approval of the organization.

MR. STEGELMEYER: We wrote the statement on the basis of the information we had in the printed form of Bill 57 dated September 9th, 1981.

As I read the bill, it doesn't say that half will go to reduce the unfunded obligation and half to the benefit of retired teachers. It says only that portion which exceeds the actuarial demands or needs of the system will be divided. That will be divided between reducing the contributions of the districts and for the benefit of the retirees. Now, if it's been amended since then --

ASSEMBLYMAN STIRLING: No, that's exactly right. You're not understanding what that means.

MR. STEGELMEYER: I'm understanding the language as I interpret it.

ASSEMBLYMAN STIRLING: Rather than take everybody's time, I'll be glad to explain it to you personally again.

MR. STEGELMEYER: Well, I want to make it clear to the audience and the people that are involved. We didn't intend to insult you or your bill. We just read it --

ASSEMBLYMAN STIRLING: I'm not feeling insulted. I'm simply feeling misunderstood when you had an opportunity to talk to me about it.

CHAIRMAN RUSSELL: Can we move on unless you have a specific question that cannot be asked later?

ASSEMBLYMAN STIRLING: Very well.

MS. STEGELMEYER: Thank you.

CHAIRMAN RUSSELL: Mr. Lucero, Police Officers Research Association of California.

MR. ACETO: Thank you, Mr. Chairman. My name is Joe Aceto. I'm a Legislative Director for PORAC in place of Mr. Lucero.

We do have a guarded support position on SCA 21 and SB 211. We also participated in the Task Force for the past year and we hope that the Legislature is on the right track in pursuing some additional funding for the retirement fund for the active retired people that are supposed to be its members.

Thank you.

CHAIRMAN RUSSELL: Any questions?

All right. Thank you.

Our next to the last witness is Aaron Read and then after Mr. Read is Mr. Robert Ford asked to make a brief statement. We have also been asked to incorporate into our record testimony by Thomas Collins on behalf of the Long Beach Unified School District on the SCA 21 and SB 211. That will be included in our record.

MR. READ: Thank you very much, Mr. Chairman, and members. Aaron Read representing the Retired Public Employees' Assocation. I'll be very brief because I have some witnesses who are active members in my association here to testify. I do want to thank the Committee for this opportunity. We've enjoyed hearing the other testimony but we think we have something a little bit different to offer.

At the outset I want to indicate to Assemblyman Stirling that his ACA 57 is the first measure that I've seen in 13 years around the Legislature that really puts across a new idea, and that is the idea of trying to share something with the retirees. The associations I represent, not only the retirees, but other active employee associations support that concept and we support working with you on, if not ACA 57, somebody else's constitutional amendment. We applaud the concept and we applaud the effort.

With that I would like to introduce the first witness that I have, Mrs. Consuelo Scully who is a local classified school retiree who lives here in San Diego.

MR. SCULLY: Thank you. At the present time I'm Legislative Chairman of Chapter 29 of RPEA, but for 37 years worked with the San Diego Unified School District first as a secretary and then assistant to the retirement counselor for that district. So I do know of what I speak.

According to the latest record we have from the Public Employees' Retirement System, average gross allowance of a classified school retiree is $221 a month. So if the teachers think they're on the low point of the totem pole, I think we're just a little bit below them.

The 50 percent cost of living which was written into the law in 1968 is where we stand today. Because of Senate Bill 90 which was a revenue and taxation bill, we have been ineffective in claiming any increase in our retirement since that time since we no longer can go to our individual school districts. We are required to go directly to the state. The state by that Senate Bill 90 was mandated to fund any improvement in classified school retiree benefits. They have consistantly refused to accept that responsibility. Retired improvements in the Legislature to include school retirees have invariably been amended, any legislation that's been presented that included us, has been immediately amended to exclude us. They have given PERS retirees, state retirees, some improvements. Not what they deserved, but at least they have given them because they have all these years been responsible for them. But they have since '73 refused to accept the responsibility for us.

It is a trust fund. PERS is a trust fund and as such is intended to benefit its members, both active and retired. A plan to disperse the earnings of the system to include a percentage to retirees seems to be the only possible solution for school retirees. Until such action is taken, we feel we cannot support any legislation. That's why we are appreciative of Mr. Stirling's efforts on our behalf.

Thank you.

MS. WELLINGTON: My name is Lois Wellington. I am Director of Organizational Activities for the Retired

Public Employees' Association of California.

We have listened to long and involved statements dealing with the complex problems of funding and funding protection. The Retired Public Employees' Association is deeply concerned for it is the only state-wide organization dedicated to the best interests of all its members: state, classified school, and contracting agency.

Let me speak to the plight of the contracting agency. There are more than 2,000 contracting agencies in the state with more than 1100 contracts. Each individual agency, retired group, must go to its own governing body to try to persuade that body to grant a benefit, a situation growing more and more difficult. $858 is the state-wide average income for a contracting agency member. Many have no other income. For instance, the City of Burbank is not and has never been coordinated with Social Security.

Since 1968 the only assured increase is the yearly 2 percent cost-of-living, and 2 percent per year in these days of double-digit inflation is unconscionable.

Retired members have invested not only money in this fund, but hopes and plans for a life of dignity and of respect. We ask your sincere concern. The quality of many lives depend on the prudent methods of expansion of investments. We certainly support efforts to provide a share in these monies. Thank you.

CHAIRMAN TUCKER: Thank you very much.

Any questions?

Dick Dunn, Vice President of Scudder, Stevens and

Clark.

MR. READ: I'm sorry, Mr. Chairman. There are two more witnesses and they'll be very brief. I've asked them to take no more than a couple of minutes each.

CHAIRMAN TUCKER: Fine.

MR. READ: The next witness is Karl Jensen.

CHAIRMAN TUCKER: Mr. Russell had to leave. He had a plane. He had another hearing to attend tomorrow morning.

MR. READ: Karl Jensen is the state-wide Director of Legislation for RPEA.

MR. JENSEN: Members of the Committee, I have given your secretary copies of my prepared statement. But in the interest of time, I have edited some of it out.

CHAIRMAN TUCKER: Please state your name for the record, sir.

MR. JENSEN: I appreciate this opportunity -- oh, I'm Karl Jensen. I am a Director of Legislation for the Retired Public Employees' Association of California. I have some comments to make on SCA 21 and related to SB 211 by Keene. Also involved in some of my statements will be remarks concerning ACA 57 and related Preprints AB 2 and 3.

Of significance I think in our current time is a news item from the <u>Los Angeles Times</u> of last week.

> "Denmark's Minority Social Democratic Government fell when its economic policies failed to win approval in a parliamentary censure vote. Prime Minister Anker

Jorgensen will continue as head of a caretaker government until special elections on December 8th ... Democratic partners refused to go along with a plan to order public and private pension plans to reinvest about $425 million, now in government bonds in the hard-hit agricultural and construction sectors of the economy."

A very stable government of Europe has fallen because of that.

To focus the interest of this interim hearing on the position of our Retired Public Employees' Association, I want to read an excerpt from a letter by our President, Claude Harman, to Governor Brown. Governor Brown had appointed Claude Harman to the Task Force on pension unit investment. A portion of this letter says:

"It would be absolutely impossible for me to obtain a favorable position on SCA 21 from the members of RPEA unless we have an indication of support for an amendment to SB 211, or some other vehicle, giving retirees a part of the anticipated increased returns generated by the passage of SCA 21. Otherwise, retirees would feel that their money was being gambled away without benefit to them."

On September the 2nd of this year I prepared a synopsis of the "Report of the President's Commission on Pension Policy" that was submitted to President Reagan. The data is 26 February, 1981. I have selected a couple items that I think are germane to this hearing.

A. The Commission takes no position on ownership or control of pension funds.

B. The Commission recognizes the inadequacy of systems with no long-term funding.

C. Problems identified included erosion of benefits due to inflation.

D. A major objective of national policy is to assure maintenance of a reasonable standard of living.

E. Pensions are regarded as deferred wages and essentially inviolate as a vested interest to each earner.

The last item, fundamental policy is that pension income is for retirement purposes. I have an aside to make here, to which I suggest that the fund is not to generate employer contributory advantages to the detriment of the stated national and state posture. I quote some legal findings of 1948 against the old state retirement employee system.

The essence of the judicial remarks is that pensions must be liberally construed to end that their beneficial purposes are broadened rather than narrowed.

I relate in a letter from PERS, the Assistant Executive Director to Mr. Bruce Russell, who is a Director in our Association of Retired Employees.

In the spring of 1981, retired judges averaged

$3218 a month pension, constitutional officers $3161, legislators averaged $873. Now, the state miscellaneous retirees, public agency retirees and classified school retirees will be identified by Mr. Robert Cowden as "low man on a totem pole," and needs no restatement of the exact figures.

In concluding my remarks, I call the Joint Committee's attention to the wording of the section of the Government Code 2200:

> "The Public Employees' Retirement Fund is a trust fund created, and administered in accordance with the provisions of this part, solely for the benefit of the members and retired members of the system and their survivors and beneficiaries."

Note that the employers are conspicuously absent from the Code Section.

I thank the Committee for their courtesy in hearing the views of Retired Public Employees' Association, and I'll be happy to answer any questions or refer them to Aaron Read.

ASSEMBLYMAN STIRLING: Just one real quick one, Mr. Jensen.

In the resolution indicating your position on SCA 21 and the trailer bill, did you question at all the need for an additional committee to evaluate the investments?

MR. JENSEN: Would you repeat that, sir?

ASSEMBLYMAN STIRLING: I'm having trouble with the bill numbers, but SB 211, you adopted a resolution on the 27th of September, '81 indicating conditional support for SB 211 if they did the one-third split on the profits from the increased revenue; correct?

MR. JENSEN: The resolution stated, and subject to changes by amendments to the Legislature, that there be a surplus undistributed earnings account established by the Public Employees' Retirement System Board of Administration, that distribution of this account be as follows: one-third thereof will be returned to the employer's account to reduce the contributions made by these agencies, one-third be returned to the employer's account and reduce the, to reduce the contribution of active employees, three the remaining one-third to be reserved to increase annual supplemental benefit payments to retirees in addition to the presently authorized cost-of-living adjustment of 2 percent per annum. That's the essence of the resolution. That's appended to the --

ASSEMBLYMAN STIRLING: I think that's a good reasonable alternative to the one that I had. But my question is, are there other onerous parts to that bill and I was wondering if the RPEA had considered those such as the Advisory Committee and venture capital.

MR. JENSEN: I'll defer to Aaron Read.

MR. READ: We haven't really looked at that that closely, those other parts, but I think we should.

ASSEMBLYMAN STIRLING: There's some speculation that the covert agenda out of the Governor's Task Force is the subsidized investment or subsidizing investment for socially responsible projects as opposed to simply not investing in socially irresponsible projects. I was wondering if RPEA was thoroughly aware of those or whether that had been exercised?

MR. READ: We have opposed every effort in the Legislature in the several years that I've been around to use those monies in some social programs such as low income housing, even urban renewal projects. We have opposed those consistently and constantly. We do favor investing money at the proper yield prevalent at the time and do not believe in subsidizing. I believe it's a violation of the fudiciary responsibility of those who handle the fund to make that decision. I don't believe that they can do that. So we oppose that.

We did support, however, the effort to move toward home mortgages. After appropriate amendments were taken to Assemblyman Elder's bill, we had no problem with it because he had amended it to provide the adequate safeguards. So we didn't have any problem, but there have been other measures that we have proposed.

ASSEMBLYMAN STIRLING: Thank you, Mr. Read. Thank you, Mr. Chairman.

CHAIRMAN TUCKER: We have another question.

MR. BALD: May I ask, if you intend in looking at SCA 21 and ACA 57, is it your intent to compare the definition of the fudiciary responsibility in those two bills and make some determination as to which definition would permit the kind of subsidized social investment and which would exclude it?

MR. READ: I think that's a reasonable thing for us to do. We have not done it yet. I think that's part of why we're here today is to have heard some of the comments that we heard today and we're certainly going to go back and talk about it tomorrow. But we have not made any judgments in those areas.

CHAIRMAN TUCKER: Thank you.

Your next witness.

MR. READ: Our next witness, and he'll be brief, is Bob Cowden, another active member of the Retired Public Employees' Association.

MR. COWDEN: Members of the Committee, it's been my pleasure to work with, as a representative of RPEA, with our President, Claude Harman, on the Task Force. I was sorry, Mr. Stirling, to see you misquoted so badly a few minutes ago, but I'll get to that quickly in a moment.

On May 8th of this year when the Task Force met in Los Angeles in the State Building, is the first opportunity that our President, Claude Harman, had to sit as a member of the Task Force. Let me read to you the heart of what we've said. This represents RPEA's position with respect to the Task Force.

"While we commend the Task Force for its foresight and diligence in developing new and innovative methods to be employed in expanding the earnings of our pension fund, we nevertheless must insist that we, the investors in the fund, retain control over the methods to be employed in expanding our investment portfolio and where the funds will be invested. In other words, it's our money, too, and we must ask: What is in it for us? It's as simple as that. That's been our position right along."

Now, others have appeared before me and you've listened all day to a lot of testimonies that pointed out the fact that the retirees, due to a number of factors including inflation, outside of the economic insult of 2 percent which we get yearly, are on the short end of the stick. Now, undoubtedly, the 2 percent was about right along about in 1962 or '63 when that was made the cost-of-living increase. But that's no longer the case.

As also was stated, AB 2674 the Boatwright bill which expires in October of '82, the second year, gives us a 10 percent increase. Thank God for that because that's been the difference between eating and not eating for some of our members. I can assure you that that's the case.

Now, we're aware of the worsening economic picture. I think everybody who can see light and hear thunder knows what's going on. It's liable to get much worse before it gets any better.

Now, our position has been with respect to the Task Force -- and I want to clear up one other misstatement or several that were made here today. I attended a number of those meetings and at no time did that Task Force ever ask for or say that those monies should be spent without PERS and STRS Board of Administration controlling the expenditures, both as to the type of expenditure and the amount within the parameters that might be set from time to time by the Legislature.

Now, all we said was that we wanted constitutional assurance that the integrity of the trust fund will be assured for all times. That was the number one consideration. We also said that as a retiree we wanted the same insurance that retirees get a fair share of the revenues flowing into the trust funds.

Now, also as was said, constitutional officers get a good pension with full COLA. That includes our Governor Pat Brown, Evelle Younger and Ronald Reagan, our President, and I'm sure he's not hollering about the COLA he gets on his retirement. We're not asking for full COLA. All we're asking for, gentlemen, is we're tired of hunting for a stale sandwich while others have a seven course dinner. We want to live in our twilight years with dignity and essential comforts.

Some wag once said, "Happiness is nothing more than a poor memory." That's not our philosophy. We may be too old to run, but sure as hell we are not too old to stand and fight for what we think is right.

ASSEMBLYMAN STIRLING: I'm sorry, I did not hear when I read your statement your position on each of the bills.

MR. COWDEN: We agreed to support the bills as long as the provisions which I just stated were met. We didn't profess anything beyond that. So long, again, as the Board Administration of STRS and PERS retains control over the investments and the amount. We have no objection to some outside experts.

MR. READ: As of right now, your ACA is the only document that I've ever seen that would move in the direction of giving retirees something, holding out some hope that we can get something more than the 2 percent that they're now tied to. We obviously know that the general fund in the coming year or two is going to be very hard pressed and the odds of our getting any monies out of that may be difficult. So we're scrapping and stretching for alternatives. That's why we essentially favor increasing the yield by whatever means possible, if it is possible. It seems to us to be perhaps our only hope.

MR. COWDEN: Again, let me say one other thing quickly. I know the hour is late.

There was reference made to housing and how they were going to dip into that money. Absolutely not. The Task Force, and I attended many meetings, and they never said anything about subsidized housing. The law says we have to invest that money at the legal going rate and everyone knows that public housing can't exist without a subsidy. Where is it going to come from?

CHAIRMAN TUCKER: I don't know that they mentioned subsidized housing. But I don't think that bill dealt with subsidized housing.

MR. COWDEN: That's right.

CHAIRMAN TUCKER: They were talking about buying mortgages,going into the secondary mortgage market.

MR. COWDEN: We're not quarreling with that. Not at all. But somebody alluded to the fact that the Task Force had talked about it. No, that was not in any of our recommendations.

Thank you.

CHAIRMAN TUCKER: Thank you, sir.

15 MR. READ: If I may, just one final piece of information, and it's for the teachers who are retired as well as the classified retirees. I do have to say, since I was a party and your consultant was a party back in the early '70's to de-pooling, the people who work in school districts really have it tough, be they teachers, the classified employees, secretarial people or managerial people or whatever, because under the current bargaining law, the Rodda Act, they cannot ask a school employer for any adjustment. It's not legal for the employer to do that. So they have to come to the Legislature, but the Legislature doesn't want to make adjustments on it because if they do, because of SB 90, the state has to pay for it all.

Well, maybe in time it will become a moot issue because the state seems to be paying more and more of education anyway. I think we're approaching 90 percent now that is state money. But there are problems, and Consuelo Scully, the first witness, mentioned those. They have no place to go. So they are really stuck. They perhaps are

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the worst off of all the retirees because of that Catch 22.

ASSEMBLYMAN STIRLING: I would ask, since I wasn't here when that happened, why did that provision end up in the legislation?

MR. READ: Well, I'm not sure. I was around when SB 90 passed. It was an effort by cities and counties to halt states mandating them to do certain things.

ASSEMBLYMAN STIRLING: But the option is left with the PERS contracting city to allow retired contracting retirees to approach, I understand, approach the City Council and ask for a judgment. Indeed, the Legislature has granted the option to PERS contracting agencies.

MR. READ: Let me make sure we're clear. What you're saying is correct for contracting cities and counties. That's one segment. We have three segments. So we'll take the one you just mentioned. That's contracting agencies.

ASSEMBLYMAN STIRLING: Why would we not have given the same option to local boards of education or county boards of education?

MR. READ: We don't. We don't have the same option. I suppose it's because there's a thousand school districts in California, and one reason perhaps is that PERS wouldn't want to administer a thousand different plans. So the school retirees and active school members are treated as one group, as a total. They're not allowed individually to go before their City Council.

So if we simply granted back, introduced legislation granting back to the local boards of education or to the county boards of education similar options as was available to contracting cities, that would address the problem; right?

MR. READ: That is certainly one way to address the problem.

ASSEMBLYMAN STIRLING: Other than an overall grant out of every PERS retiree.

MR. READ: I think we could support that. That's one of two solutions that I've known of. I think that's one possible way to go.

ASSEMBLYMAN STIRLING: I prefer ACA 57.

MR. READ: Thank you vere much.

CHAIRMAN TUCKER: Mr. Cox has a question.

MR. COX: What would you think of legislation that would amend PERS law and also the collective bargaining law that would allow school districts to bargain on behalf of their retired school members for cost-of-living increases?

MR. READ: I believe that sort of dovetails with what Assemblyman Stirling had mentioned. I think we would support that strongly, that opportunity to return to the district level and make that attempt. Because, you see, at the present time, we can't even ask there. When we ask at the Legislature, there essentially is no money ever.

CHAIRMAN TUCKER: Thank you very much, Mr. Read. You always come well prepared, even with your cheering section today. I knew somebody was behind it.

Let's see. We have a Mr. Robert Ford.

MR. FORD: Thank you, Mr. Tucker.

CHAIRMAN TUCKER: And anybody else who wants to testify, who feels compelled to come up and say something and read your name into the transcript, please come into the front row there and I'll give you two seconds each. Go ahead, Mr. Ford.

MR. FORD: Thank you. My name is Robert W. Ford. I am a Retirement and Disability Committee Chairman for the California Department of Forestry Employees' Association.

CHAIRMAN TUCKER: You have two minutes, too.

MR. FORD: To the best of my knowledge, I'm the only one testifying today from an active employee organization that has active employees working for the state of California. I think to that end, it would be prudent to identify that basically we're in agreement with what was said here and suggested and, particularly, are keen on Mr. Stirling's ACA 57. We feel if it's politically feasible every effort should be made to eliminate the percentile investment constraints from existing regulations for PERS and STRS investments and certainly, if not, they should be given the most flexible compromise possible. We believe that there should be provided in the statutes a definition of a "prudent expert." We feel also that if bonding is necessary for those with fudiciary responsibility, that can be also considered. We feel that with those changes -- and I can address PERS more than STRS because my knowledge is basically with PERS -- with those changes we feel that PERS should be given the opportunity to produce a higher investment return rate over a reasonable period of time. Give them that chance to perform. If necessary, provide for a periodic legislative review or study of how they're doing. For example, once a year or what have you. Then if they do not perform a legislative proposal such as Mr. Stirling's preprinted AB 3 could be considered. We believe that right now that particular bill is premature. Once STRS and PERS have had the opportunity to provide a higher investment return, then that particular element should be brought to bear. Until then we feel it would be inappropriate.

I thank you, Mr. Tucker, Mr. Stirling.

CHAIRMAN TUCKER: Mr. Ford, thank you very much for your testimony.

Anyone else feel compelled to say two words?

Thank you.

MR. BROWN: I'm Ronald Brown from the California Teachers Association. I'm the Bert Scaggs of the south.

I just wanted to enter into the record that we have a position on SCA 21 which is neutral at this time. We don't feel strongly one way or the other. We have people that feel strongly every way. So since we are all over the road on SCA 21, at present, our legislative body has a neutral position which we continue to study.

CHAIRMAN TUCKER: You have taken the position of no position?

MR. BROWN: No. We've taken the position of everybody for himself. Seriously, we are continuing to study that.

211 we have a position of approve. We believe that much of this -- and that was before the last amendments where we feel the concept is good.

The reason I came up was because on Preprint 3 I'm sure that Assemblyman Stirling knows we have a position of support for this. I think those are the bills they just amended.

CHAIRMAN TUCKER: Just a moment. Mr. Cox has a question for you.

MR. COX: Ron, what do you think CTA's position would be relative to legislation that would amend STRS law and ERA law to allow school districts to bargain with the active employee group for cost-of-living expenses for retired teachers?

MR. BROWN: I believe that some people in our organization are going to testify at another hearing which you're going to have in Sacramento. Isn't there going to be another one? I better not say. I would imagine we would be in favor of it, but to the best of my knowledge we do not have a position.

CHAIRMAN TUCKER: Okay. Thank you.

MR. BROWN: Thank you.

CHAIRMAN TUCKER: Anybody else?

Well, I want to thank all you folks for testifying and those who didn't testify for your attentiveness. The meeting is adjourned. Thank you.

(Thereupon the Joint Interim Hearing of the State Assembly Public Employees and

Retirement Committee and the State Senate Public Employment and Retirement Committee was ajourned at 4:30 p.m.)

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METHODS FOR EVALUATING PERFORMANCE AND ENHANCING PORTFOLIO RETURN OF A PUBLIC RETIREMENT SYSTEM INVESTMENT PROGRAM

A STATEMENT PRESENTED IN TESTIMONY TO THE

CALIFORNIA STATE LEGISLATURE

ASSEMBLY AND SENATE PUBLIC EMPLOYMENT AND RETIREMENT COMMITTEES

SAN DIEGO, CALIFORNIA

BY

DR. BRIAN M. NEUBERGER

PROFESSOR OF FINANCE

SAN DIEGO STATE UNIVERSITY

NOVEMBER 17, 1981

I. INTRODUCTION

Mr. Chairman, Members of the Committee, I consider it a privilege to appear before you today. For the record, my name is Professor Brian M. Neuberger, and I am a Professor of Finance at San Diego State University.

The main purpose of this hearing, as I understand it, is to explore ways in which state, county and local governments can improve the return performance of their public retirement system pension programs. There are several questions regarding pension fund portfolio performance that I will address in this testimony. Before discussing those issues, however, I think that it is important to briefly review what appears to be the present and prospective economic environment in which we will consider these topics.

With research that has been done on investment performance by me as well as other researchers, I hope that what follows will generate a lively discussion among those present here at this hearing of the joint legislative committees on public employment and retirement. The purpose of this paper is to make constructive, positive comments that will be helpful to all parties involved in a public pension program.

II. CALIFORNIA'S ECONOMIC FUTURE

A projection of California's economic future can best be analyzed by a forecast of the U.S. economy. The U.S. economy plays such a vital part, and is a major component as to how the individual states perform. A look at the future U.S. economy is the logical jumping off point.

A. Current U.S. Economic Environment -- It is now apparent by looking at various economic indicators that the U.S. is in the midst of another recession which officially commenced the second quarter of 1981. For all intents and purposes, we have been in a long period of "stagflation" or an economy that has had almost no real inflation adjusted growth since the first part of 1979. Some of the major sectors in our economy, such as housing and the auto industry, have been in prolonged slumps due mainly to historically high interest rates and inflation of the double-digit variety. For example, housing starts recently hit a new 6 1/2 year low and the unemployment rate for October surged to an adjusted rate of 8%. In addition, other indicators such as industrial production and stock prices have been predicting significant slumps in the economy.

If the current drop accelerates through the fourth quarter, 1981 and the first quarter, 1982 we can expect continued decline in inflation to single-digit numbers, and interest rates should recede more. The "prime rate" charged by major commercial banks to their most credit-worthy corporate borrowers has already declined to 17% this month from an all-time high of 21 1/2%. Both the housing and auto industries could rebound in a major way if and when short-term and, more importantly, long-term rates decline. In addition, the Economic Recovery Act of

1981, signed by the President and now in effect, involved major tax cuts which should give a significant long-term boost to capital spending.

Both stock and bond prices in the short-run weakened in the face of the new tax law. There is little doubt that investors and savers have been "burned" for such a long time in the 1970s that they have become very cynical. It is hard for them to believe we can really get government spending increases under control in the face of recession, major increases in defense spending and larger-than-expected federal deficits.

The key behind the tax bill was to encourage incentives to save as well as to invest. In other words, we need to stimulate savings by rewarding savers with real rates of return after inflation, while at the same time creating incentives to borrow these increased savings by the private sector. One of the strong arguments presented by "supply-side" economics is that we have to adequately reward rather than penalize savers and investors. In the end the only way our society can justify a higher real standard of living is by both (1) working harder and/or smarter, and (2) doing it with better plant and equipment.

The problem in the near term is that fiscal policy is considered to be still relatively loose in spite of cuts in federal budget increases and a fairly tight monetary policy carried out by the Federal Reserve System. Possibly we should consider realistically the alternative of a tighter fiscal policy and a looser monetary policy.

I personally feel we are now in a watershed era which will continue for the next 3-4 years. What changes are made in our tax laws and government regulations during this period will contribute greatly to predicting the state of our economy in the year 2000. For example, in

July, 1973 I wrote a series of articles that appeared in The San Diego Union (July 22-24) which indicated, based on a careful review of economic variables, that we should expect the rate of gain of the Consumer Price Index (CPI) to accelerate on a trend basis. It forecasted that by the end of the 1970s we should expect inflation in the range of a 10% to 14% annual rate. The writings indicated that inflation would probably emerge as the major economic problem confronting businessmen, investors, and government bureaucrats throughout the remainder of that decade.

I am now of the opinion that with several more years of adjustment in the economy, the economic and investment prospects for financial assets as opposed to real assets looks bright for the last half of the 1980 decade. For example, I think that excess returns brought about by inflation and speculation in residential real estate will not occur again for a long time. The implementing of instruments, such as shared appreciation mortgages (SAMs) and adjustable rate mortgages (ARMs), has effectively dampened real estate speculation during the past two years. Lenders are no longer willing to subsidize borrowers through granting them a fixed-rate long-term loan. If and when we regain an extended period of relatively low inflation and economic stability we may well see fixed-rate loans come back into vogue. In the meantime, I am rather optimistic for equities particularly during the next few years. My discussion of investment by public pension programs into equities vs. fixed-rate obligations will be reviewed in more detail in later sections of this paper.

B. California Economic Environment — The real economic growth of the U.S. economy averaged only 2.8% in the 1970s whereas it came out a much higher 3.8% in the 1960s. Various economists project that the

California economy will be a bit more robust in performance than the general U.S. economy—growing at over 3% in the 1980s. Whereas the general economy has been under continued declining trends of growth due to various external shocks to the system, such as oil prices. California's growth should be both higher and more stable. Major industry segments such as defense contractors, tourism, agribusiness, high technology, and foreign trade should contribute greatly toward a strong state economy. In contrast, the reduced speculation in real estate as well as a concern for adequate growth policies and water will keep growth in Southern California from growing at excessive rates in the future. There still seems to be no conclusive evidence at this early date that the lowered property tax rates mandated by Proposition 13 have had either a favorable or unfavorable effect on economic growth in the state. It should be noted, however, that economic growth is higher and unemployment rates in California are lower than they were prior to its passage (excluding current recession).

In summary, the near-term economic outlook for the U.S. looks bleak at best. Fiscal and monetary policy has until recently kept interest rates high, thus depressing both the stock and bond markets as well as the overall economy. A major concern is that the government may not get a handle on the federal deficit and will continue to crowd out private industry in the financial markets, therefore limiting real growth. As previously indicated, I think the long-term trends in inflation, economic growth, and interest rates will continue to trend toward much more favorable positions commencing the latter half of 1982 and as we move further out into this decade.

III. STATE AND LOCAL GOVERNMENT PENSION PLANS

It is interesting to note that state and local government employees retirement systems, both in the state of California as well as in other jurisdictions, are established and function under relatively complex laws and regulations. These statutes dictate very narrowly the major aspects of both administrative and investment policy. The results of these inherent inflexibilities has caused most government retirement funds to react much slower to changes in the economy than private corporate plans. For instance, trustees of public pension funds have been much slower than private plans to move away from heavy involvement in government bonds and into corporate bonds and equities. Some of these public pension trusts were even invested in a major way into low-yielding, tax exempt bonds witness the financial crisis of New York City several years ago.

There are a number of explanations behind this traditionally peculiar investment behavior exhibited by many public retirement funds. I think it would be helpful to review some of these constraints that affect public funds, such as Public Employees' Retirement System (PERS) and other state and local funds. While this behavior is sometimes understandable they are, for the most part, outmoded. These factors include:

1) Often trustees of pension plans and their fund managers have been unduly constrained by obsolete state laws regulating the handling of public funds. Some of these issues are addressed at this hearing today which might make a significant improvement in fund performance.

2) The trustees or board members are typically elected or appointed public officials rather than professional investment managers. In addition, there frequently have been resistance to incur the costs of hiring top-notch professionals and attracting well-qualified private citizens to lend their expertise to the management of these funds.

3) Public pension programs are subject to review by political partisans whereas public plans are normally private issues. This type of atmosphere does not provide an incentive for innovative or aggressive investment management of assets.

4) There is always the temptation, as noted earlier, to relieve strained government budgets by using pension funds as a captive buyers of employing-government's bonds, despite their relatively low yields. For example, this was true in the early years of PERS. They were restricted from investing into other than U.S. bonds and municipal bonds until 1947. It was not until 1967 that the system was permitted to invest in equities. Equities, as of fiscal 1980, now represent around 23% of PERS' total assets at cost.

5) Government pension plans, such as PERS, require significant employee contributions in addition to those of the employer. Thus, mistakes in investment policy have a much more severe effect on the welfare of state and local government employees than on corporate employees. The results of employee contributions creates pressure toward maintaining a more conservative investment policy.

It is important to note, however, that most public pension funds are becoming more effectively managed as state laws are changed and the use of professional investment advisers has been increased. As I am sure the executive officers of both PERS and State Teachers' Retirement

System (STRS) would indicate, the result has been that equity purchases have increased in recent years. State and local funds developed into a major class of equity buyers. The likely, most important reason, behind this trend has been the continued liberalization of state laws that have in the past severely restricted the percentage of portfolio assets that could be held in equity investments.

For example, a flow of funds analyzed for the year 1979 found that the distribution of assets in public funds consisted of 18% in government securities, 24% in stocks, and 48% in bonds. This does represent a significant change since the early 1950s when a typical fund consisted of over 50% just in government securities. In contrast, there is a much wider array of portfolio compositions among private pension plans. 1979 averages indicate, however, that they averaged only 11% in government securities, 23% in bonds, and 57% in equities (common and preferred). A typical state pension plan currently operates with less than 25% of the total portfolio in equities. States such as New York, Ohio, Wisconsin, and Michigan, however, either currently or project asset diversification in equities (not including real estate) to exceed 30%. (Source: Pension World, October, 1981, p. 17.)

IV. PRIVATE PENSION FUNDS

A pension fund is normally defined as a plan established and maintained by an employer primarily to provide for the systematic payment of benefits to employees after their retirement. Under these plans, company contributions are usually paid into a trust fund at a bank or trust company. The trustee's investment powers are regulated primarily by the precise terms of the trust agreement. The most frequently incurred terms in order of popularity among private funds are as follows:

1) The trustee is given relatively complete discretion to invest the assets as he or she believes most appropriate.

2) The trustee is given discretion within certain prescribed limits, such as the maximum percentage of assets that may be invested in various kinds of assets.

3) Investments may be made only with the approval of a designated co-trustee, typically a senior corporate officer.

4) Investments are made at the direction of the company, with or without the advice of outside counsel. The larger the company, the more likely they will use an internal management approach.

A. Factors Affecting Private Fund Investment Policies -- There are several factors which influence pension fund investment policies:

1) All income and capital gain of fund investments are tax exempt.

2) In general, little legal restriction on pension fund investing other than the usual fiduciary principle that a trustee must deal with at arm's length with the trust.

3) The manager is usually relatively unhampered by liquidity considerations until a pension plan is quite old.

4) There is typically a strong incentive for the investment manager to try to maximize investment return and thereby reduce the employer's cost. These costs include the actuarial assumptions as well as cost pressures presented by unions to increase real retirement income levels.

B. Investment Policies — Private pension trustees became increasingly aggressive in their investment policies with the passage of time since World War II. Just like public pension plans, they used to be heavily invested in government bonds and high-grade corporate bonds. They gradually became aware that the nature of pension trusts made them ideally suited to undertake common stock investments because of the long-term nature of their liabilities and slight liquidity needs. These changes in portfolio asset allocation have increased to about 60% of pension assets today held in equities and most of the balance in corporate bonds and short-term securities. It should be noted that both preferred stocks and state and local government bonds are relatively unattractive to these tax-exempt institutions.

One of the major criticisms of the Employee Retirement Income Security Act of 1974 (ERISA) and current trust law is that under the "Prudent Man Rule" it focuses solely on the risk of loss, and on minimizing such risk on each security in a portfolio rather than on the portfolio as a whole. It is interesting to note that judicial decisions have stressed the nominal preservation of capital and not the preservation of purchasing power. This means that you may well be an ultra-conservative fund manager, but it does not necessarily equate with being prudent, i.e., obtaining an inflation-adjusted real return. The danger here is that it doesn't matter whether something is an attractive investment move if it is diversification. It would be unfortunate if investment policies became a function of minimizing legal concerns as opposed to representing the product of an organized risk-return analysis as we have been discussing.

V. INFERIOR PENSION FUND MANAGEMENT PRACTICES

There appears to be several other factors, in addition to those already discussed, that frequently contribute to below average performance of both public and private pension funds. The main causes appear to be (1) incurrence of expenses in an unsuccessful search for undervalued securities, (2) superfluous diversification, (3) inability to utilize macroeconomic forecasts, and (4) inflexible utilization of the investment alternatives available.

The major reasons for typical inadequate performance will be briefly discussed in the following paragraphs.

1) The Search for Mispriced Assets — Fund managers of pension funds, bank trust departments and mutual funds (stocks and bonds) search for "good buys" — that is, securities that are considered to be undervalued. Both security analysts and portfolio managers use the tools of fundamental stock analysis and/or technical analysis to detect these mispriced assets. Empirical research has indicated that when funds become excessively large, research expense generally does not pay off. In fact, the cost of search often reduces the net return to the holder below what they could have expected to earn if they had selected the securities randomly.

2) Overdiversification of Funds — Most funds own well over 100 different securities (equities and fixed-rate obligations). As a case in point, PERS, as of June 30, 1980, held 124 different common stocks, 4 convertible preferred stocks and literally hundreds of different types and maturities of fixed-rate bonds (governments and corporates) as well as real estate mortgages. It should be recognized here that the fund

has been in existence since 1932 and now totals around $15 billion at book value. It has been demonstrated that "superfluous" diversification tends to lower the entire portfolio's performance as witnessed by reviewing Chart 1. In general, managers often make recommendations using fundamental and/or technical analysis without regard to the security's correlation with the existing portfolio or the market. Practices such as this explain why many large funds' risks are not lower.

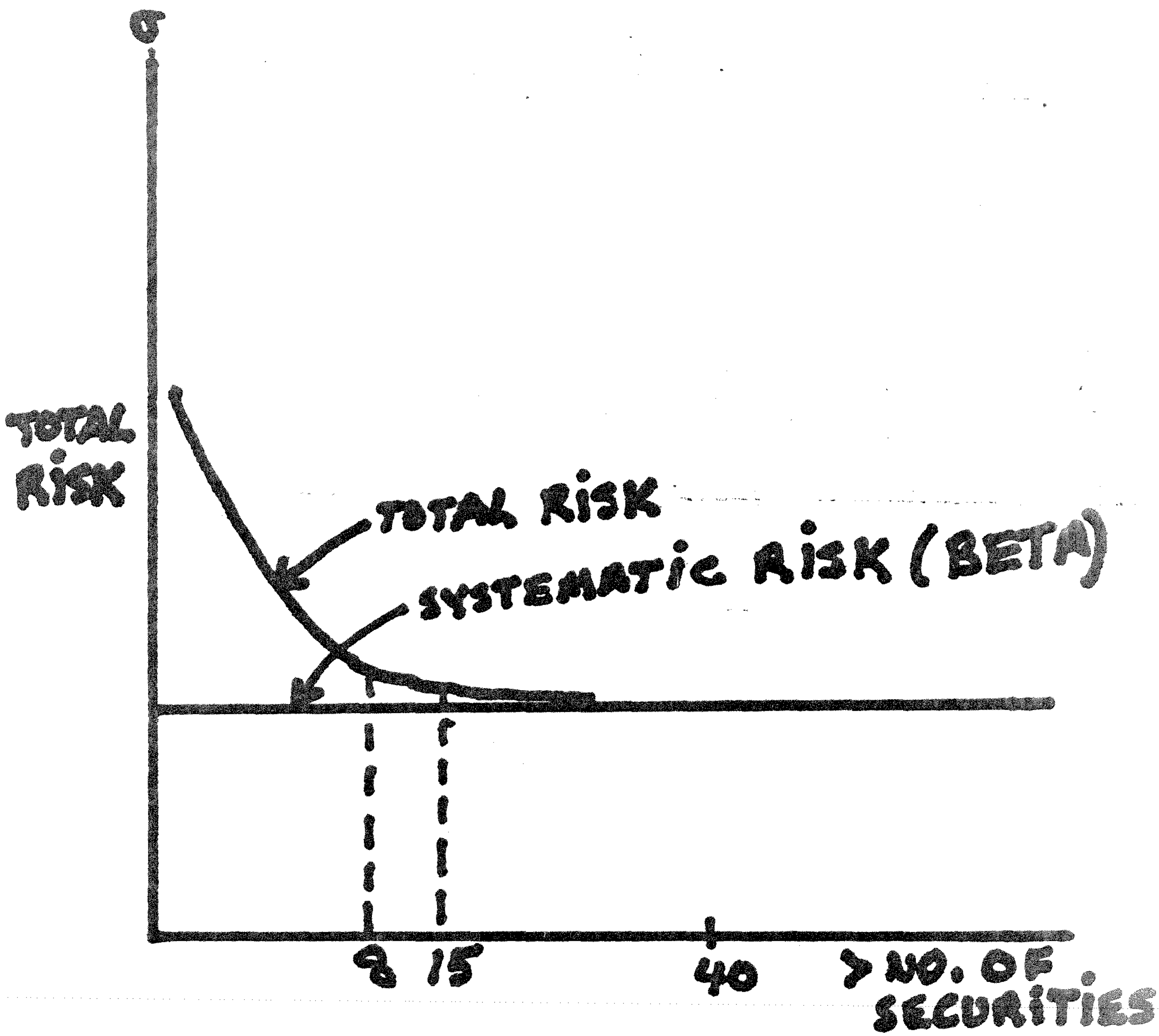
In addition, this over-diversification also tends to reduce the portfolio's returns. Large, efficient security exchanges, such as the New York Stock Exchange (NYSE), do not contain many securities which are significantly mispriced. Thus, nearly all funds hold superfluously diversified portfolios in which a majority of their securities can be expected to turn in only ordinary performances at best. Not only will this strategy tend not to minimize risk or maximize return, but it will create unusually high expenses keeping accurate information files and hiring additional portfolio managers.

3) Some Funds Are Too Large — Various evidence indicates that economies of scale exist for funds up to say $500 million. However, beyond this total (especially with equities) you likely start to encounter diseconomies of scale. One major reason for this is that when becoming actively involved in periods of market instability or when certain issues are undergoing major reevaluation, they can destabilize security markets. This destabilization effect is one of the major reasons for superfluous diversification as discussed earlier.

4) Funds' Tendency Not to Effectively Use Macroeconomic Forecasts — Fluctations of the whole economic activity reflect fluctuations of

Chart 1

NAIVE DIVERSIFICATION



the economy's many parts. Moreover, while the parts tend to move in unison, there is also an observable sequence. When one part changes direction, it pushes another part, which pushes still another. It is logical, therefore, that if we wish to predict turning points of the whole economy, we should try to isolate and study those parts which usually turn before the whole.

The National Bureau of Economic Research (NBER) has made a continuing project of searching for "leading," "coincident," and "lagging" indicators of general economic activity.

Pension fund managers can benefit from using various economic indicators of present and future performance of macroeconomic variables. Some of the important economic indicators that fund managers should actively include in their analysis to justify proper asset allocation policy for funds include the following:

1) Gross National Project (nominal and "real" inflation adjusted)

2) Disposable personal income

3) Sector forecasts of activity in various industries comprising the nation's economy

4) Unemployment rate (now and forecasted)

5) Rate of inflation (which index should we use?)

6) Interest rates

7) Likely actions taken by the monetary (the Federal Reserve System) and fiscal (Federal Administration and the Treasury) authorities

8) Corporate profits

9) Housing starts

10) Automobile sales

11) International environments (economic and political)

I think we can all agree that the above listed factors are the major variables which will eventually determine security prices (equities and fixed-rates obligations). Evidence strongly suggests that mutual funds, as well as other large fund managers, stay heavily invested in risky securities during bull and bear markets alike. They apparently have little or no advance warning of a general market decline and take little or no action to shift to investments (for example, cash, puts, or certain bonds) which would be profitable during it—or at least would resist it.* Unfortunately, most funds do not seem to utilize economic forecasting.

*J. L. Treynor and K. K. Mazuy, "Can Mutual Funds Outguess the Market?" Harvard Business Review, January-February 1965, pp. 63-76. F. J. Fabozzi and J. C. Francis, "Mutual Fund Systematic Risk for Bull and Bear Markets," Journal of Finance, 1979.

VI. METHODS FOR EVALUATING PORTFOLIO PERFORMANCE

Billions of dollars are kept invested in marketable securities in the U.S. In fact, the Annual Report of Financial Transactions of Public Retirements Systems in California for the fiscal year, 1979-1980, indicated total assets at book value of over $33.2 billion. In addition, these 77 defined benefit plans had unfunded obligations of some $29.3 billion. All portfolios' average rates of return vary widely over time as the market alternates between bullish and bearish periods. Therefore, average rates of return are not satisfactory measures with which to classify a pension fund's risk and return. Certain quantitative risk measures, however, are fairly stationary over time. For example, two quantitative risk measures are appropriate for measuring the historical risk of portfolios. One is the standard deviation of historical rates of return, and second, the use of a portfolio's beta coefficient may be used to measure systematic or undiversifiable risk. These funds' beta coefficients may be classified as explained in Table 1.

TABLE 1

PORTFOLIO SYSTEMATIC RISK MEASURES DEFINED

Range of beta	Level of funds' risk	Description of price volatility
.5 to .7	low	Share prices vary about half the rate of the market index.
.7 to .9	medium	Share prices rise about 80% of the rate of the market index.
.9 to 1.3	high	Share prices vary directly with the rate of change in the market index.

In assessing the performance of a portfolio, it is necessary then to consider both risk and return. Ranking portfolios' average returns ignores the skill with which they minimize risk and is therefore an oversimplified performance measure. The critical need is for an index of portfolio performance which is determined by both the return and the risk of a portfolio.

The rate of return computation recommended by the Municipal Finance Officers Association does not adequately measure favorable or unfavorable portfolio performance. It is computed as follows:

$$RR = \frac{I}{1/2\ (A + B - I)}$$

where

RR = Rate of return on total assets

A = Fund value at beginning of year

B = Fund value at end of year

I = Earned investment income during year.

This formula purports to be a conservative one because it only includes assets calculated at cost (book value) and earned income from interest, dividends and realized gains and losses on sales of assets. While this formula has its purpose supposedly over the long-run, it inadequately measures true portfolio performance. A much better appraisal of the post-war portfolio performance would be the use of the market values of these assets in developing a Holding Period Return (HPR) concept as follows:

$$HPR = \frac{P_{t+1} - P_t + \overset{i_t}{d_t} + C_t}{P_t}$$

where

HPR = denotes the one-period rate of return in the tth period. The tth period can be whatever period you are interested in—this year, next week, or last quarter. It must be adjusted to reflect that the fund is investing new employee and employer contributions during the year that would automatically increase the fund's book value.

The P_{t+1} and P_t terms are dollar quantities defined as the market price of the securities at the beginning of period t + 1 and period t, respectively. I_t and d_t reflect the dollar amount of coupon interest paid on the bonds and dividends received from stock investments. C_t represents realized capital gains or losses on the portfolio.

Sharpe's Portfolio Performance Measure — Dr. William F. Sharpe has developed one such index of portfolio performance as follows:

$$S_i = \frac{\text{risk-premium}}{\text{total risk}} \quad \frac{\bar{r}_i - R}{\sigma_i}$$

where

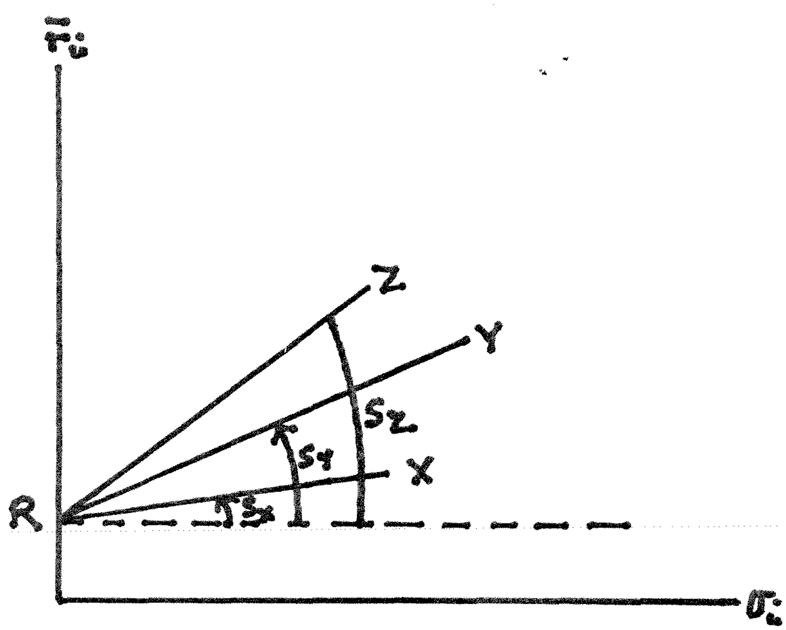
$\bar{r}_i$ = average return on ith portfolio

σ_i = standard deviation of returns for portfolio i

R = riskless rate of interest

The numerator $\bar{r}_i - R$ is called the risk-premium for portfolio i. The risk-premium is that return over and above the riskfree rate (normally considered 90-day Treasury bills) which is paid to induce investors to assume risk. Sharpe's index of performance generates one (ordinal) number which is determined by both the risk and return of the portfolio being assessed. For example, given Chart 2 below, S_i measures the slope of the solid line starting at the riskless rate R and running out to asset i. Thus, $S_z > S_y > S_x$ indicates that asset Z is a better performer than asset Y, and Y is better than X. The fact that the portfolios have different average returns or risks does not hinder a direct comparison with Sharpe's performance index.

Chart 2: Sharpe's index of portfolio performance measures the ratio of risk-premium to total risk.



VII. METHODS FOR ENHANCING PORTFOLIO RETURN OF A PUBLIC RETIREMENT FUND

One of the tasks I was assigned to address for today's hearing are ways in which we can improve the rate of return on public retirement funds without increasing their inherent risk levels. We have already reviewed the similaries and differences between public and private funds and have discussed some of the major methods to evaluate such fund performance. It is strongly recommended at the outset of this section that funds, such as PERS and STRS, spend a significant amount of time in reviewing questions of pension policies, across the board, from asset allocation to actuarial techniques and assumptions to benefit design. It is important to recognize that no pension fund (public or private) can cope with the problems of investment policy without reference to an analysis of the liabilitities of the plan, the effect of actuarial assumptions and methods upon what modern portfolio theorists would call the risk preference of the fund.

There appears to be two major reasons that have caused an increasingly unfunded liability to build up in recent years in both public and private plans. (1) The first factor is that certain actuarial procedures turned out to be unrealistic. For example, average age of retirement drops below what was anticipated, as well as funding liabilities over periods such as 30 years when average life expectancy of a retiree may be as close as only 10 years. In addition, new benefits may be funded over a 25 period when in fact the average remaining work life of the employee may only be 15 years. This has a tremendous effect upon pension expense as witness comparing the payments on a 30 year mortgage as opposed to a 20 year mortgage.

(2) Investment returns often were not adequate in recent years. Actuaries make an assumption about what future experience will be in estimating the current financial condition of the plan. In effect, this number becomes the rate at which all estimates of future liabilities are discounted to determine their present value. These nominal rates are quite low, compared to today's norms. For example, PERS' interest rate assumption beginning in 1978 was 6 1/2%. 9% is about the highest anyone uses. Typically, however, the good investment performance of the 1960s did not continue during most of the 1970s. Many pension funds got into trouble because they amortized the short fall each year instead of contributing the difference to the fund immediately. Thus, liabilities grew as investment performance failed to match the plan's assumptions.

The generally poor return performance of the 1970s caused most public and private plans to make their actuarial assumptions more realistic. The current crisis in the Social Society system has been getting some realistic debate after years of accelerated increases in inflation adjusted levels of pension benefits and corresponding rapid increases in the fund's unfunded liabilities. No significant progress has yet been legislated in this area as yet.

A. Goal -- Achieve a Floating, Real Rate of Return -- Most models of historical performance of the stock and bond markets analyze asset allocation policy based on a fixed-rate of return. Most of these models have suggested that an optimal mix of assets to be around 60% in equities and 40% in bonds. These models have a problem because they set policy for a plan with a floating rate liability as if it were a plan with a fixed-rate liability. Thus, the question to be asked is would pension assets be allocated differently if the fund's objective was to achieve a floating rate of return rather than a fixed return? In other words, the goal of PERS, STRS and other local pension funds should be to achieve a real rate of return, one in excess of the rate of inflation.

What follows is an analysis of inflation adjusted history of returns on various financial assets since World War II. (The charts come from data supplied by the Frank Russell Company.) Chart 3 shows how many times the Standard and Poor's 500 (S&P 500) stock index beat the inflation rate as measured by the Consumer Price Index (CPI) which I think we all can agree, generally overstates actual inflation due to the heavy weight given housing costs. As you can see in the chart, stocks provided a real rate of return quite often (72% of the time in 5-year intervals between 1952-1979 and 100% of the time in 20-year holding periods).

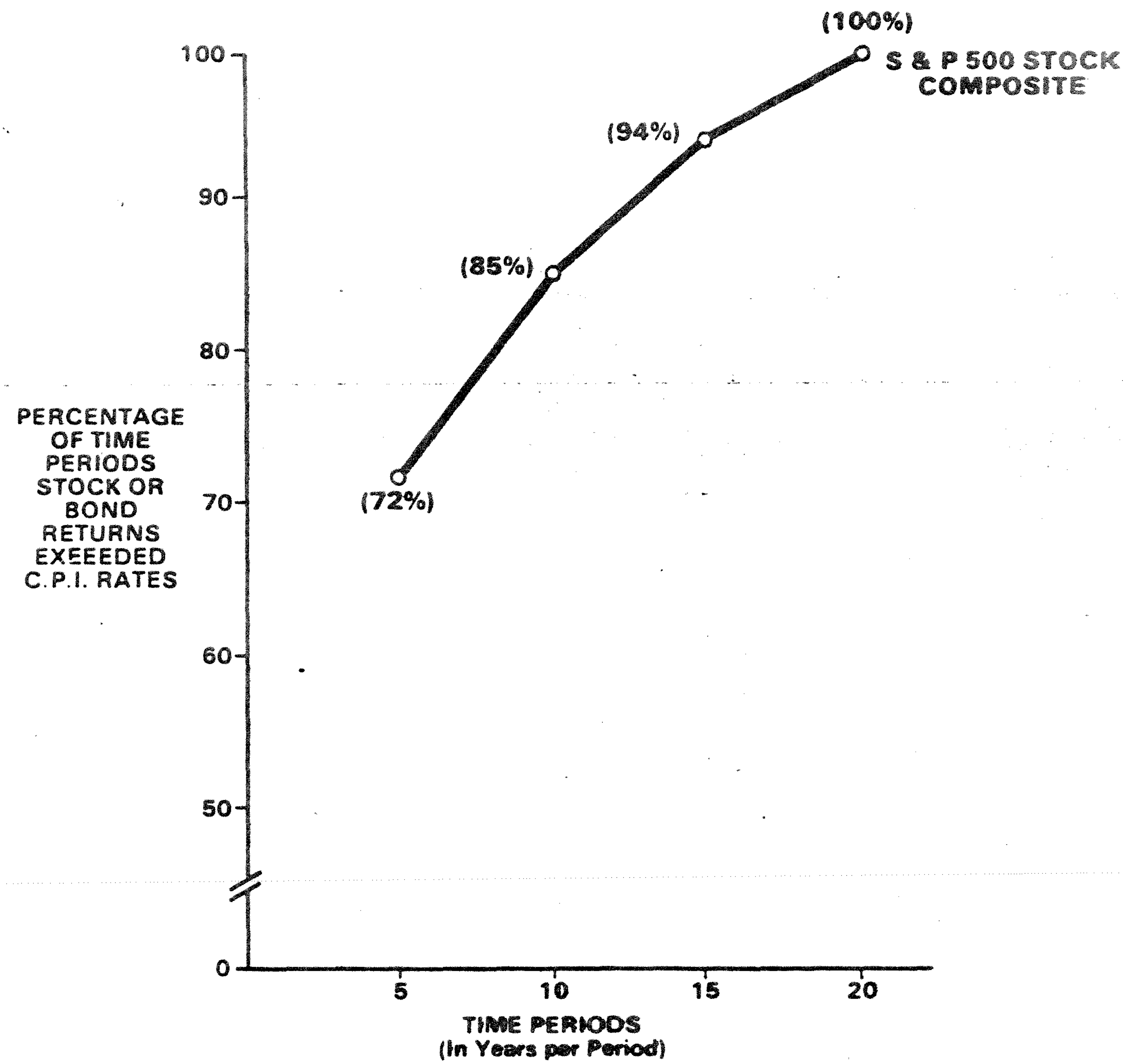
In contrast, note the record of the S&P High Grade Bond Index over the 1952-1979 period in Chart 4. It provided a real return only half the time and, importantly, did not improve with age as did stocks.

Next, (Chart 5) look at the results that could be achieved by an actively managed bond fund that attempts to take into account swings in interest rates to lengthen or shorten the average maturities of their bond portfolios. Three mutual bond funds who were in continuous existence over this period were averaged and you can see chances of success were somewhat improved. About two-thirds of the time they equaled inflation, but the probability of success does not increase over time.

Finally, in Chart 6, it is interesting to note the results of what a proxy for a money market fund would have done over this same 1952-1979 period. It was assumed that if you invested in 90-day Treasury bills

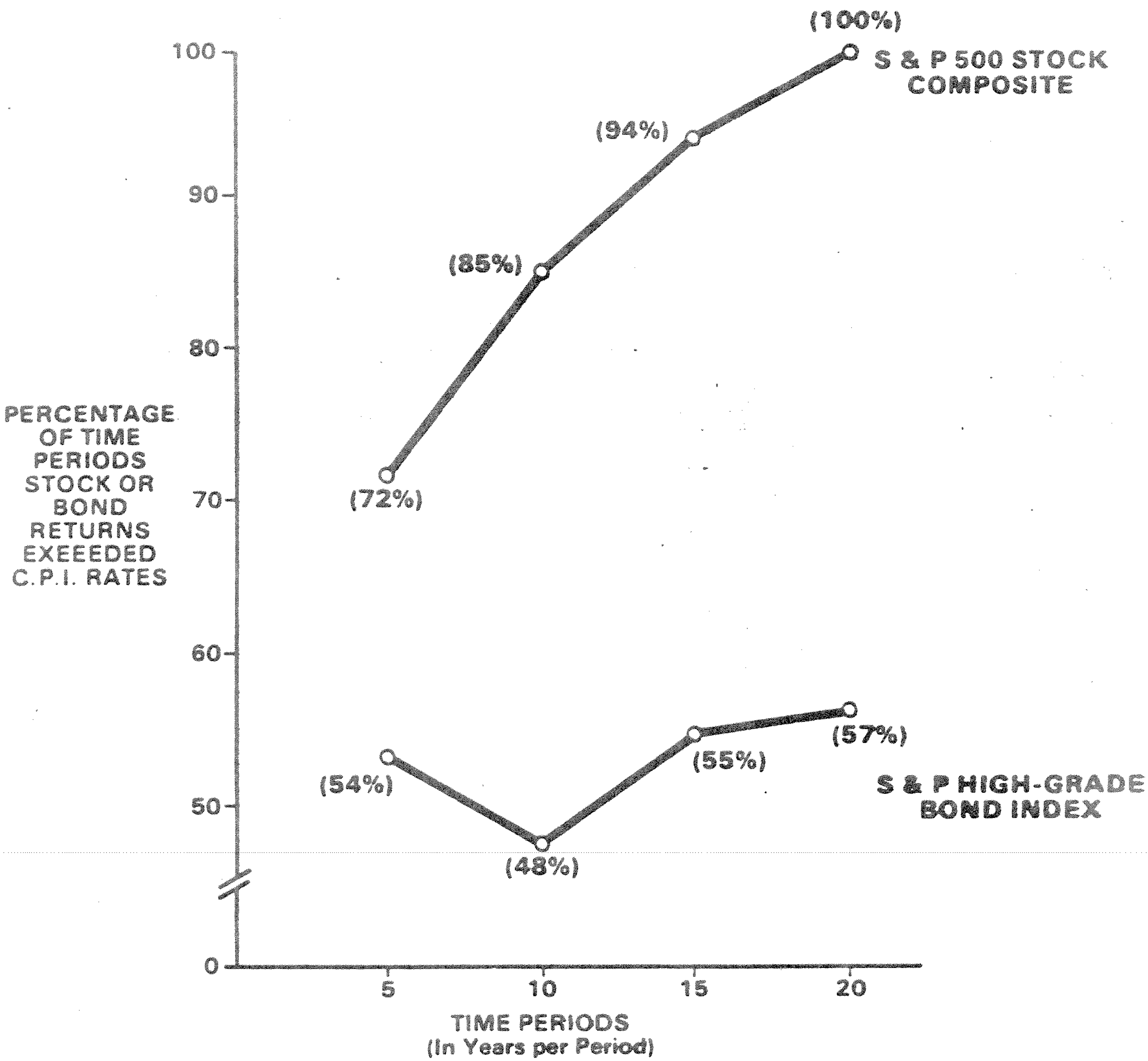
STOCK AND BOND RETURNS COMPARED TO THE C.P.I. INDEX

(five, ten, fifteen and twenty-year time intervals)



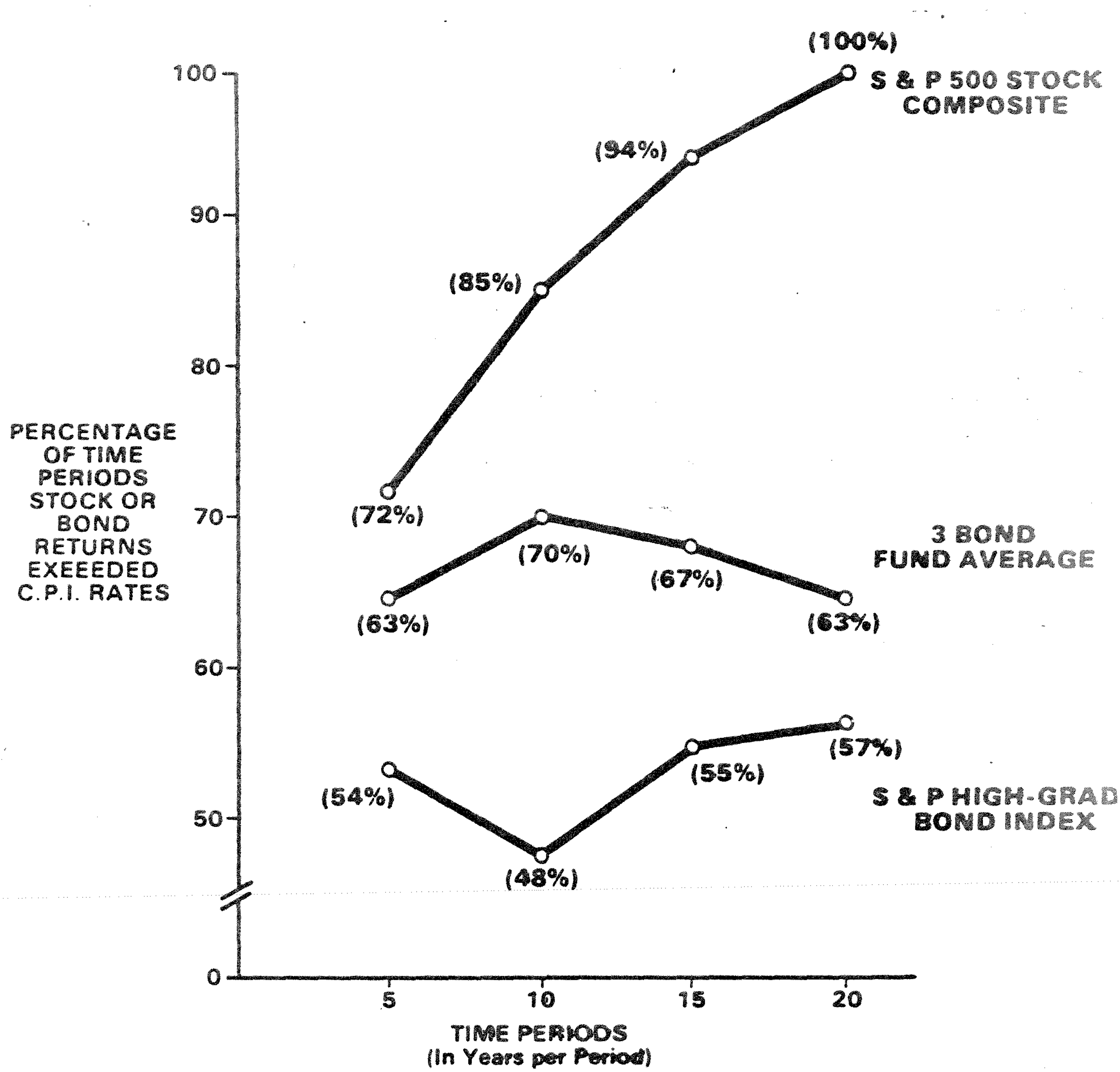
STOCK AND BOND RETURNS COMPARED TO THE C.P.I. INDEX

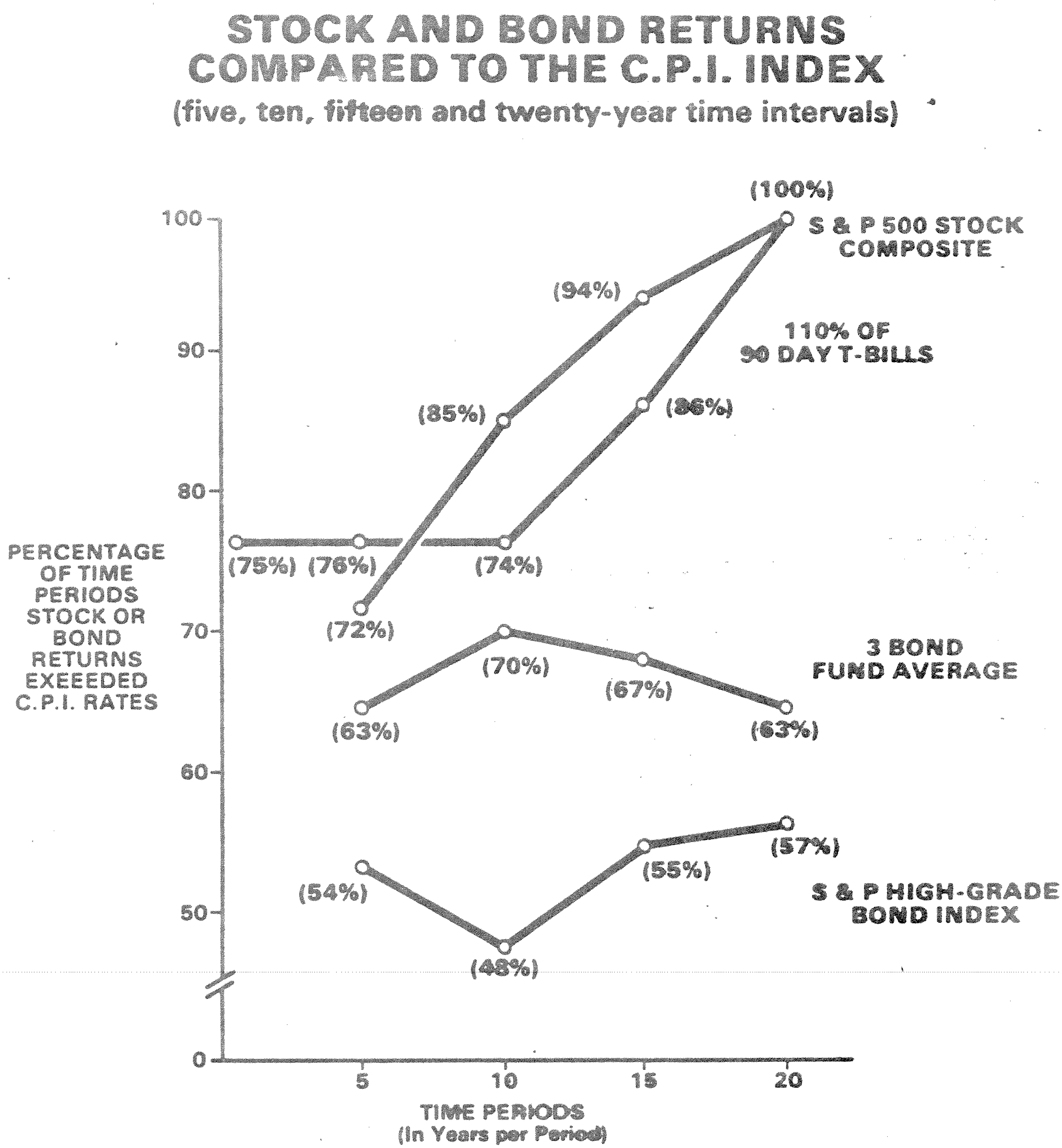
(five, ten, fifteen and twenty-year time intervals)



STOCK AND BOND RETURNS COMPARED TO THE C.P.I. INDEX

(five, ten, fifteen and twenty-year time intervals)




STOCK AND BOND RETURNS
COMPARED TO THE C.P.I. INDEX
(five, ten, fifteen and twenty-year time intervals)
(100%)
S & P 500 STOCK COMPOSITE
(94%)
110% OF 90 DAY T-BILLS
(85%)
(86%)
(75%) (76%)
(74%)
(72%)
PERCENTAGE OF TIME PERIODS STOCK OR BOND RETURNS EXEEEDED C.P.I. RATES
(70%)
(67%)
3 BOND FUND AVERAGE
(63%)
(63%)
(57%)
(55%)
(54%)
S & P HIGH-GRADE BOND INDEX
(48%)
100
90
80
70
60
50
0
5
10
15
20
TIME PERIODS
(In Years per Period)

during the period, multiplied it by 110% to approximate the added return available if one invested in other near riskless securities, such as negotiable certificates of deposit and commercial paper. As you can see, the proxy for the money market fund did a much better job of keeping up with inflation than did fixed-rate bonds. Chart 6 also should show the composite results.

B. Inflation-Adjusted Returns (1952-1979) — Chart 7 shows, for example, that equities as measured by the S&P 500 Index generated inflation adjusted returns over 1-year time horizons of 7.2% and 10-year holds of 5.1%. In contrast, even the three bond fund average inflation adjusted returns was only 1.4% for 1-year holds and .7% for 10-year holding periods.

C. Volatility of Returns — A very important issue, of course, is the volatility of those returns in inflation adjusted terms. As Chart 8 indicates, you can see that equities had the highest volatility. However, bonds had volatilities 50% to 70% of those produced by stocks even though they earned inflation adjusted returns, not much more than 10% of those were equities.

In contrast, the money market funds not only beat inflation by as much as bonds, but they also tracked it quite closely, showing by far the lowest inflation adjusted standard deviations. Analysis of data since 1920 forward and just the post-war period indicated even more strongly the benefits of being in various mixes of equities and cash equivalents and not in fixed-rate bonds.

D. Assume a Certain Real Rate of Return Over a 5-Year Period — For example, Chart 9 shows the probability of earning a 2% real return, using investment performance for stocks and cash equivalents from 1952

Chart 7

INFLATION ADJUSTED RETURNS
1952 TO 1979 DATA

	TIME PERIOD		
	1 YEAR (N = 28)	4 YEAR (N = 25)	10 YEAR (N = 19)
S&P 500	7.2%	6.1%	5.1%
S&P HIGH GRADE BONDS	(1.5%)	(0.9%)	(1.2%)
3 BOND FUND AVERAGE	1.4%	.7%	.7%
110% OF T BILLS	0.2%	0.3%	0.6%

INFLATION-ADJUSTED STANDARD DEVIATION

1952 TO 1979 DATA

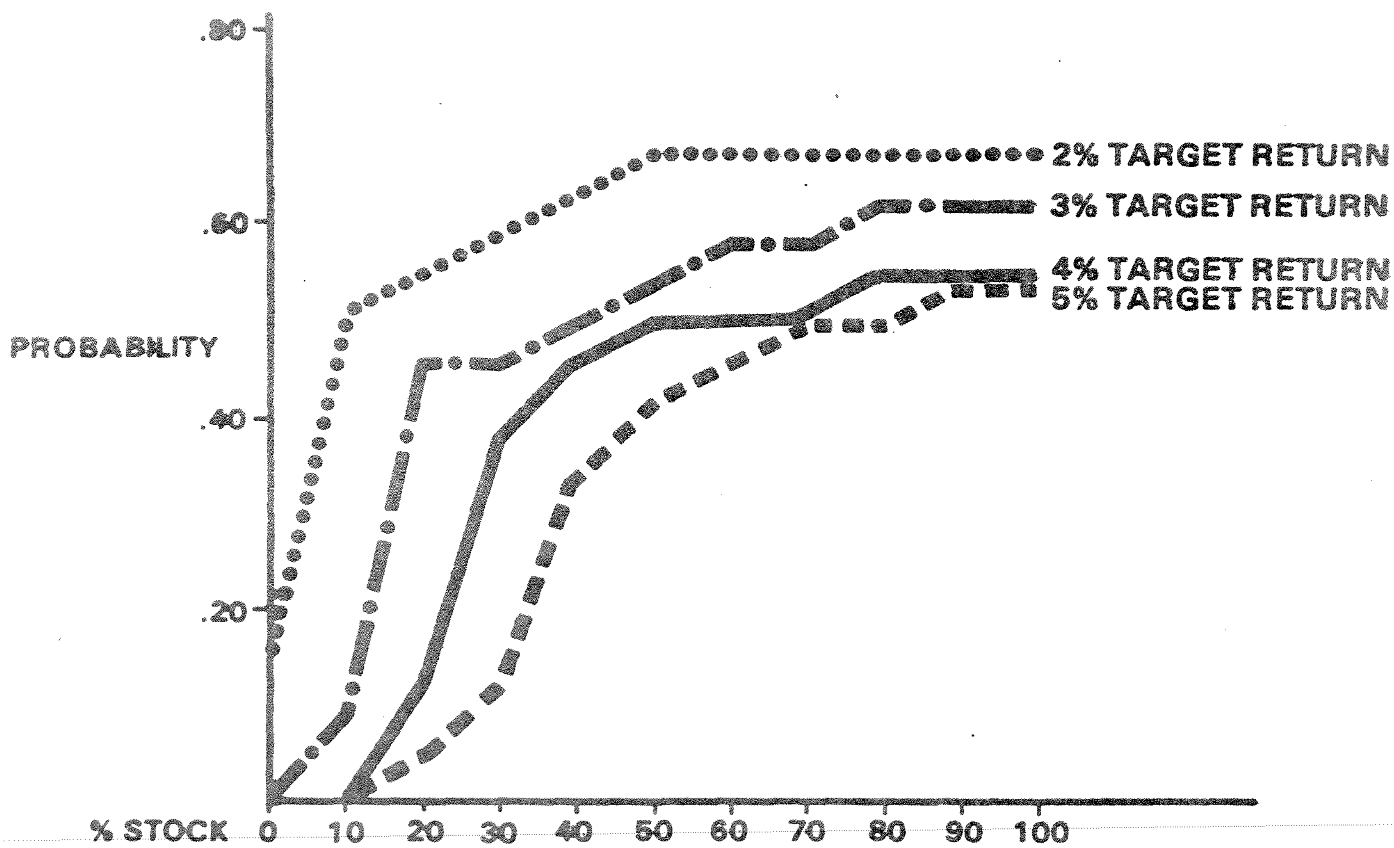
	TIME PERIOD		
	1 YEAR (N = 28)	4 YEAR (N = 25)	10 YEAR (N = 19)
S&P 500	19.6%	7.8%	6.0%
S&P HIGH GRADE BONDS	7.0%	3.0%	1.4%
3 BOND FUND AVERAGE	12.3%	5.1%	3.2%
110% OF T BILLS	1.7%	1.2%	0.8%

Chart 8

REAL RATES OF RETURN FOR STOCKS (S & P 500) AND 110% OF TREASURY BILL RATE

TIME PERIOD: 1952 - 1979

TIME HORIZON: 5 YEARS



INFLATION ADJUSTED EXPECTED RETURN		2%	3%	4%	5%
INFLATION ADJUSTED DEVIATION STANDARD	1.2		3.3		7.8

to 1979 as the basis for predicting results. You can see that the probability of success rises steeply with the first additions of equities, and levels off at about two-thirds. The chart also shows the results for a 3%, 4% and a 5% real return. Notice at 5%, the chances of success top out about 50%, when equities reach 85-90% of the portfolio. This is reasonable since 5% was about the average inflation adjusted return for equities over the period.

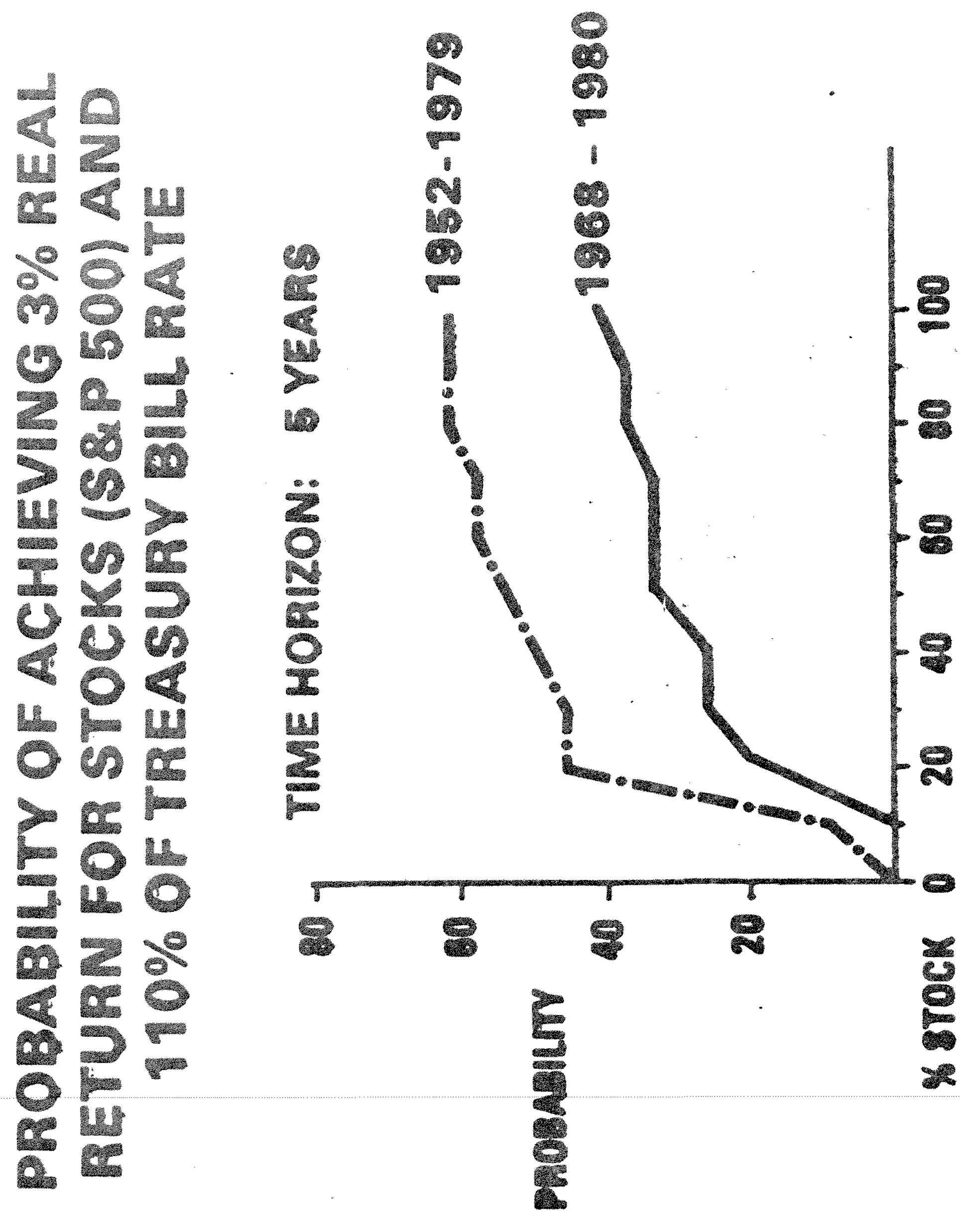
Chart 10 shows the investment results for the 1968 to 1980 period. During this time frame, stocks and money market instruments on average provided almost exactly the same inflation return, just about none. Stocks continued to be significantly more volative in inflation adjusted terms. The chart shows that the probability of achieving a 3% real return on 1952-1979 data as well as only the 1968-1980 period. It is readily apparent that the chances of success were much lower in the latter period.

It is interesting to observe, however, that the 1968-1980 line continues to rise to the right. Despite the fact that the inflation adjusted returns for stocks and money markets were virtually identical for the period, about zero, adding stocks always increased the chance of achieving a 2% real return over a 5-year interval.

These two lines have in common a characteristic which is virtually universal amont all the curves examined. The first 50% of the portfolio held in stocks substantially increased the chance for success. Or, again to oversimplify, there is a penalty to be paid for having less then 50% of the portfolio in stocks.

E. Can a Public Pension Fund Tolerate Greater Price Volatility? — This is a question of great importance. Is our risk aversion so great

Chart 10


PROBABILITY OF ACHIEVING 3% REAL RETURN FOR STOCKS (S&P 500) AND 110% OF TREASURY BILL RATE
TIME HORIZON: 5 YEARS
1952-1979
1968 - 1980
PROBABILITY
80
60
40
20
% STOCK
0
20
40
60
80
100

that we cannot go on to the logical result and invest the portfolio heavily in stocks? It is contended that short-term volatility can be easily managed by a large, well diversified pension fund. There is little need for liquidity due to continuing contributions of employees and employers plus fund cash flows to meet current obligations to retirees. Actuaries already take into account investment performance volatility by amortizing the gains or short falls over the actuarial interest assumptions.

Thus, a pension fund the size of PERS and STRS are classic examples of a long-term investor that seeks to maximize return without undue concern over current income. It can afford, because of a defensive armament of actuarial techniques, to be extraordinarily indifferent to short-term volatility if it does so in the pursuit of long-term real gains. In other words, even though interest rates are currently close to all time highs, much thought should be given to gradually making major reductions on existing bond portfolios and reinvesting a significant amount of funds gradually toward a diversified portfolio of equities.

It is recognized that we have been in a bear market in bonds (interest rates moving upwards) over the vast majority of time since World War II. Bonds have averaged out during this interval as "Certificates of Confiscation." However, the yield spreads between dividend yields on equities and interest yield on bonds are currently unusually favorable towards investing new funds in long-term bonds.

Continued heavy investment in fixed-rate long-term assets to fund a floating rate obligation is justified only if the fixed-rate asset provides a useful anchor to windward. If the anchor is unnecessary, so are the fixed-rate assets. In other words, it would appear to be gambling to fund an inflation-sensitive risk with long-term fixed-rate assets.

VIII. RECOMMENDATIONS AND CONCLUSIONS

The purpose of this testimony has been to address some of the major issues pertaining to evaluating and enhancing return performance of public retirement programs. In addition, similarities and differences between private and public retirement investment programs were discussed and suggestions made on how to increase rates of return on pension funds while maintaining high fiduciary standards and prudence.

The following preliminary recommendations are made in light of this analysis. They include the following:

1) Increase the flexibility of both public retirement program trustees as well as fund managers to meet the needs of fund sponsors, fund recipients, fund managers and actuaries. Adequate safeguards should be incorporated in law to insure a well balanced and adequately protected public investment plan.

2) A major way to attract and maintain a high level of expertise on retirement boards is to adequately compensate them for their preparation time as well as meeting time. The board seat allocation should be reconstituted to attract people with a variety of expertise in setting pension plan policy.

3) One of the conclusions of this paper is that funds such as PERS and STRS should gradually increase their asset allocation into equities to at least the 50% level. It is true that at present yields from equities are generating a zero risk premium. We currently expect some further declines in interest rates and increases in bond prices. However, in the long run, fixed-rate assets have not proved out in generating real inflation adjusted returns to pension funds. An increase in short-term securities should also be considered.

4) Funds, such as PERS and STRS, should carefully consider the writing of CALL options against their existing equity portfolios in order to enhance return and reduce risk.

5) Consider reducing the size of such funds as PERS and STRS into smaller amounts either managed internally and/or externally. They have not been able to demonstrate superior forecasting abilities, especially in light of their hugh size and superfluous diversification (see Chart 11 and Tables 2 and 3).

6) Recommend a careful and gradual increase in real estate equities and at the same time moving away from fixed-rate real estate mortgages. Consider increasing real estate equities to at least 10% of total portfolio. The purpose of this represents one way of hedging. This analysis does rest on a premise that is arguable, namely, that one can deduce future investment performance from past experience.

7) Consider that the asset allocation policies are affected by the choice of time to maturity in mortgages and bonds and will produce different results under various market conditions. Pension fund managers must be able to forecase accurately the future if they want to tell what portfolio mix and maturity will be best to maximize return and minimize risk in the future.

Evidence presented in this paper has demonstrated that pension fund managers can live with long time horizons of up to 30 years as well as short-run equity volatility. Even though we can afford long time horizons, there still exists a great amount of peer pressure from trustees for short-term performance. In addition, the nature of the typical fund manager is one who is short-run oriented.

8) Due to extreme levels of diversification, hugh funds should consider developing passive index portfolios in order to reduce expense costs and better insure adequate returns on equity portfolios.

9) Include measures of portfolio performance which reflect market values of the funds to include total realized and unrealized returns from equities as well as bonds.

10) Major attention must be given to lowering the significant unfunded liabilities totaling some $29.3 billion in California plans only.

11) Employees "crediting" rate should be increased from the current level of 6 3/4% and/or the pension fund should become fully "vested" after so many years. For example, vesting could increase from a scale of zero to 100% over a period of 10 years. Currently, employees cannot take employer funds with them when they leave government service. In the interim, they are severely penalized by receiving an unduly low rate of return on their contribution.

12) Finally, recommend that a thorough study be commissioned by each public pension fund to review past performance and develop careful policies aimed at improving investment performance in keeping with rapid changes expected in the financial markets during the 1980's decade.

RISK RETURN TRADEOFF

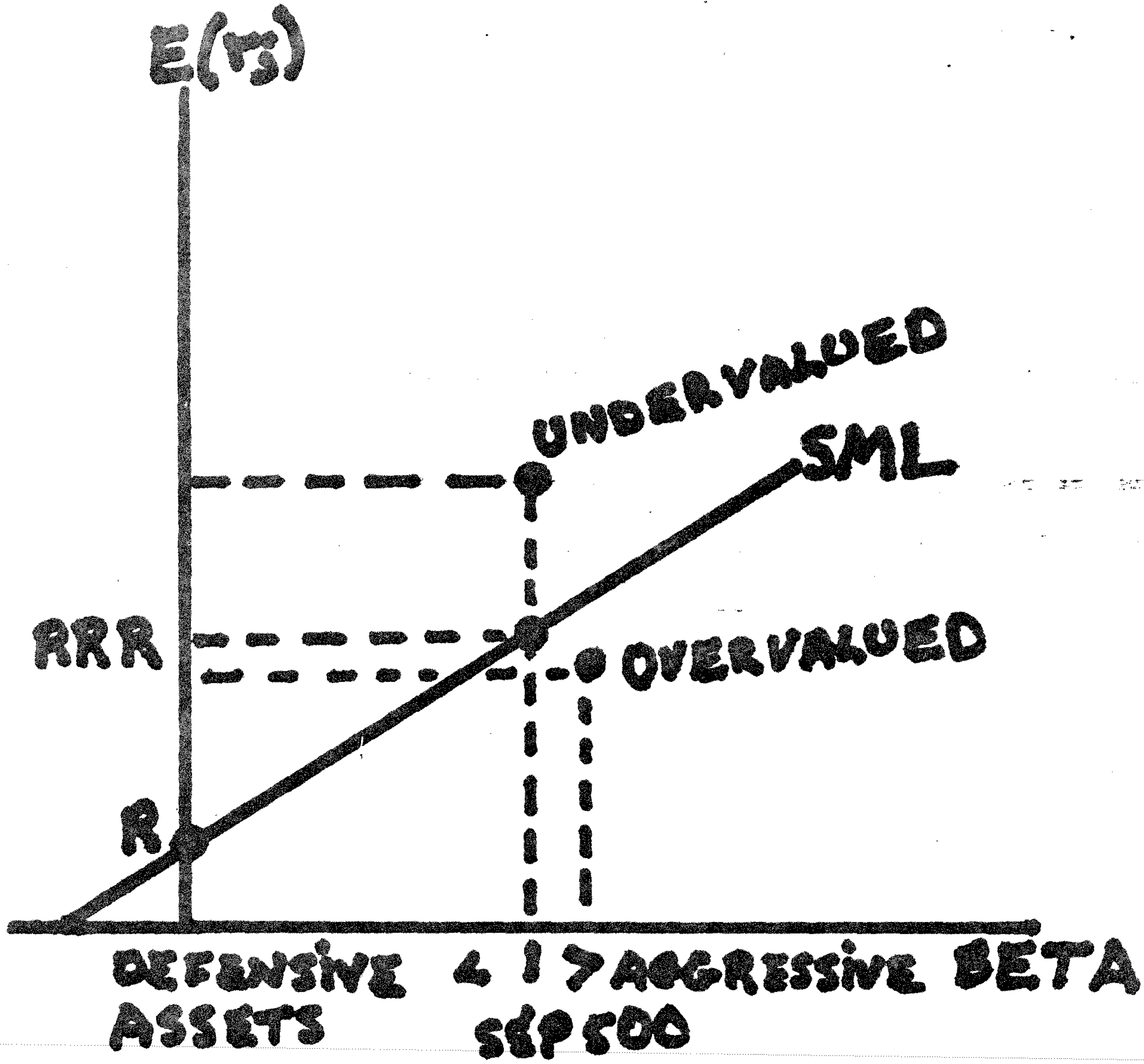


Table 2

Percent Annualized Time-Weighted

Rate of Return

	Dec 71-80	Dec 75-80	June
PERS Stocks	5.2	14.5	14.8
Salomon Brothers Bond Index	4.2	4.3	-3.1
Dow Jones Industrials	6.4	13.7	12.7
S & P 500 Index	8.5	17.6	17.1

Source: AG Becker

Percent Annualized Dollar-Weighted

Rate of Return

	Dec 71-80	Dec 75-80
PERS	6.9	14.1

Table 3

COMMON STOCK PORTFOLIO
COMPARATIVE STATISTICS

June 30, 1981

			PERS	S&P 500
1.	Volatility compared to Standard & Poors' 500 Index. (Beta)*		1.02	1.00
2.	Price/earnings ratio on latest 12 month earnings		10.5	10.0
3.	Current yield based on market value		4.7%	5.1%
4.	Historical per annum earnings growth rates	5 years	15.5	14.9
		10 years	14.1	13.2
5.	Historical per annum dividend growth rate	5 years	16.9	14.7
6.	Return on corporate equity	1 year	17.1	16.3
		5 years	16.7	15.7
7.	Debt to capital ratio		22.8	25.2
8.	Dividends as percent of earnings ---5 year average		35.9	39.3
9.	Reinvested earnings as percent of income ---5 year average		64.1	60.7
10.	Implied sustainable growth rate in dividends and shareholders equity from reinvested income	1 year	11.2	11.1
		5 years	11.0	10.2
11.	Implied total return (line 10 plus line 3)	1 year	15.9	16.2
		5 years	15.7	15.8

Source: Indata

*Beta (Market sensitivity) a measure of the extent a portfolio fluctuates relative to the extent the S & P 500 Index fluctuates.